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TRANSCRIPT OF RECORD

Supreme Court of the United States

OCTOBER TERM, 1952

No. 290

**ERNEST A. WATSON AND M. GLADYS WATSON,
PETITIONERS,**

vs.

COMMISSIONER OF INTERNAL REVENUE

**ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT**

PETITION FOR CERTIORARI FILED AUGUST 25, 1952

CERTIORARI GRANTED DECEMBER 8, 1952

United States
Court of Appeals
for the Ninth Circuit

ERNEST A. WATSON and M. GLADYS
WATSON,
Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

Transcript of Record

Petition to Review a Decision of The Tax Court
of the United States

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[Clerk's Note: When deemed likely to be of an important nature, errors or doubtful matters appearing in the original certified record are printed literally in *italic*; and, likewise, cancelled matter appearing in the original certified record is printed and cancelled herein accordingly. When possible, an omission from the text is indicated by printing in *italic* the two words between which the omission seems to occur.]

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APPEARANCES

For Petitioner:

A. CALDER MACKAY, Esq.

ARTHUR MCGREGOR, Esq.

HOWARD W. REYNOLDS, Esq.

CHARLES J. HIGSON, Esq.

For Respondent:

A. J. HURLEY, Esq.

ERNEST A. WATSON and M. GLADYS
WATSON,

Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

DOCKET ENTRIES

1948

June 1—Petition received and filed. Taxpayer notified. Fee paid.

June 3—Copy of petition served on General Counsel.

July 21—Answer filed by General Counsel.

July 21—Request for hearing in San Francisco filed by General Counsel.

July 27—Notice issued placing proceeding on San Francisco calendar. Service of answer and request made.

Aug. 16—Motion to transfer place of hearing to Los Angeles, California, filed by taxpayer.
8/17/48 Granted.

1949

Sept. 27—Hearing set Dec. 5, 1949, Los Angeles.

1949

Dec. 6, 7, 8 and 9—Hearing had before Judge Turner on merits. Appearance of C. J. Higson filed. Amendment to petition filed. Answer to amendment filed. Stipulation of facts filed at hearing. Briefs due 4/17/50. Replies due 5/17/50.

Feb. 16—Transcript of hearing 12/6/49 filed.

Feb. 16—Transcript of hearing 12/7/49 filed.

Feb. 16—Transcript of hearing 12/8/49 filed.

Feb. 16—Transcript of hearing 12/9/49 filed.

1950

April 3—Motion for extension to May 17, 1950 to file briefs and to June 17, 1950 to file reply brief, filed by taxpayer. 4/5/50
Granted.

May 17—Brief filed by taxpayer. Copy served.

May 17—Brief filed by General Counsel.

June 19—Reply brief filed by taxpayer. Copy served.

June 19—Reply brief filed by General Counsel.

Dec. 7—Findings of fact and opinion rendered, Turner, J. Decision will be entered under rule 50. 12/8/50 Copy served.

1951

Jan. 23—Respondent's computation filed.

Feb. 6—Hearing set Feb. 14/51 on respondent's computation.

1951

Feb. 14—Hearing had before Judge Kern, on settlement. Referred to Judge Turner. (Uncontested.)

Feb. 15—Decision entered, Turner, J., Div. 8.

May 11—Petition for review by U. S. Court of Appeals, 9th Circuit, filed by taxpayer.

May 11—Proof of service filed.

May 28—Statement of points and designation of parts of record, with proof of service thereon, led by taxpayer.

May 28—Designation of contents of record with service acknowledged thereon filed by taxpayer.

June 5—Supplemental designation of record with service acknowledged thereon filed by General Counsel.

The Tax Court of the United States

Docket No. 18856

ERNEST A. WATSON and M. GLADYS
WATSON,

Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION

The above named petitioners hereby petition for a redetermination of the deficiency set forth by the Commissioner of Internal Revenue in his notice of deficiency bearing symbols -LA:IT:90D:LHP, dated March 8, 1948, and as a basis of their proceeding allege as follows:

I.

The petitioners are individuals, husband and wife, with residence at Santa Ana, California. A joint return for the period here involved was filed with the Collector of Internal Revenue for the Sixth District of California.

II.

The notice of deficiency, copy of which is attached and marked "Exhibit A", was mailed to the petitioners on March 8, 1948.

III.

The taxes in controversy are income taxes for the calendar year 1944, and are in the amount of \$24,101.35.

IV.

The determination of tax set forth in the said notice of deficiency is based upon the following errors:

(A) Respondent erred in adding to petitioners' income the sum of \$40,833.33, alleged to represent ordinary income from the partnership operations of T. J. Dofflemyer & Sons.

(B) Respondent erred in failing to determine that the entire profit from the sale of petitioners' one-third interest owned by petitioner M. Gladys Watson in agricultural property located near Exeter, California, constituted proceeds from the sale of capital assets within the purview of Section 117 of the Internal Revenue Code.

(C) If the Court determines that a portion of the proceeds received from the sale of said agricultural property, as indicated above, constituted ordinary income and not capital gain, then the respondent erred in determining that the fair market value of the growing crop at the date of sale allocable to petitioner, M. Gladys Watson, exceeded the sum of \$5,916.76.

V.

The facts upon which the petitioners rely as the basis of this proceeding are as follows:

(a) Petitioners are individuals residing at Santa Ana, California. During the entire calendar year 1944, petitioners were married and living together. Petitioners filed a joint income tax return, Treasury Form 1040, for the calendar year 1944, wherein was reported the entire income and deductions of both spouses.

(b) During the year here under review petitioner, M. Gladys Watson, owned as her separate property an undivided one-third interest in agricultural land, consisting of orange grove and peach orchard, located near Exeter, County of Tulare, State of California, together with improvements and equipment located thereon. Said property was acquired on or about January 1, 1942, and was sold to one J. W. C. Pogue through an escrow agreement with the Security Title Insurance and Guarantee Company of Visalia, California, on August 10, 1944. The cost on other basis to petitioner, M. Gladys Watson, of said undivided one-third interest at the effective date of sale was at least \$14,320.34, and the net amount received by petitioner, M. Gladys Watson, after deducting selling expense, was \$62,526.17, all of which was returned as income and tax paid thereon to the Collector of Internal Revenue for the Sixth District of California at Los Angeles, California.

(c) Said agricultural property consisted principally of an orange grove and a small peach orchard. The peach crop on said property was substantially matured at the date of sale and the proceeds therefrom, amounting to \$1,729.74, were turned over to

the purchaser in accordance with the terms of the sale agreement. The expense of producing the peach crop was \$3,107.04. The fruit upon said orange trees was set on or about July 1, 1944, and at the date of the contract of sale (August 10, 1944) was undeveloped and unmaturing. Said fruit was not completely grown or matured until on or about December 15, 1944.

(d) Upon information and belief petitioners allege that because of the hazards incident to growing orange crops, the fruit on the trees at the date of the sale had no fair value or readily realizable market value separate and apart from the land itself. Petitioner M. Gladys Watson's share of the expense of producing the orange crop to the date of sale was \$5,340.18. If the Court finds that such growing crop of fruit was stock in trade or other property, the income from which is subject to tax as ordinary income, and not real property, the income from the disposition of which is subject to capital gains tax, then the petitioners allege that the fair market value of the growing crop did not exceed the expenses of producing same to the date of sale, or \$5,340.18.

(e) The property was sold as real property without any agreement of the seller or the buyer as to allocation between the growing crop as distinguished from the land. All of said property covered by said sale was property used in petitioner's trade or business of a character which is subject to an allowance for depreciation, as provided in section 23 (1) of the Internal Revenue Code, held for more than six

months, and real property used in the trade or business held by petitioner for more than six months and was not property of a kind which would properly be includible in the inventory of petitioner, nor was it property held by petitioner primarily for sale to customers in the ordinary course of trade or business.

Notwithstanding these facts, the respondent has erroneously determined that \$40,833.33 of the selling price of \$62,526.17 (petitioner M. Gladys Watson's one-third interest therein) was for the sale of fruit growing on the trees subject to tax as ordinary income, and that the provisions of section 117 (j) of the Internal Revenue Code were not applicable to such portion of the sales price.

Wherefore, the petitioners pray that The Tax Court of the United States hear and determine this appeal and render judgment in accordance with the foregoing.

Respectfully submitted,

/s/ A. CALDER MACKAY

/s/ ARTHUR MCGREGOR

/s/ HOWARD W. REYNOLDS

/s/ CHARLES J. HIGSON

State of California,

County of Los Angeles—ss.

Ernest A. Watson and M. Gladys Watson, being duly sworn, say: That they are the petitioners named in the foregoing petition; that they have read the said ~~petition~~ and know the contents thereof; that the

10 *E. A. Watson and M. G. Watson vs.*

same is true of their own knowledge, except as to those matters which are stated therein on information or belief, and as to those matters they believe them to be true.

/s/ ERNEST A. WATSON

/s/ M. GLADYS WATSON

Subscribed and sworn to before me this 27th day of May, 1948.

[Seal] /s/ DOROTHY ERBEN,

Notary Public, County of Los Angeles, State of California.

My Commission expires Sept. 28, 1951.

EXHIBIT A

Treasury Department, Internal Revenue Service
417 South Hill Street, Los Angeles 13, California
Office of Internal Revenue Agent in Charge,
Los Angeles Division
LA:FT:90D,LHP

March 8, 1948

Mr. Ernest A. Watson and Mrs. M. Gladys
Watson, Husband and Wife,
Route No. 1, Box 170, Santa Ana, California.

Dear Mr. and Mrs. Watson:

You are advised that the determination of your income tax liability for the taxable year ended December 31, 1944 discloses a deficiency of \$24,101.35, as shown in the statement attached.

Exhibit A—(Continued)

In accordance with the provisions of existing internal revenue laws, notice is hereby given of the deficiency or deficiencies mentioned.

Within 90 days (not counting Saturday, Sunday, or a legal holiday in the District of Columbia as the 90th day) from the date of the mailing of this letter, you may file a petition with The Tax Court of the United States, at its principal address, Washington 25, D. C., for a redetermination of the deficiency or deficiencies.

Should you not desire to file a petition, you are requested to execute the enclosed form and forward it to the Internal Revenue Agent in Charge, Los Angeles, California, for the attention of LA:Conf. The signing and filing of this form will expedite the closing of your return by permitting an nearly assessment of the deficiency or deficiencies, and will prevent the accumulation of interest, since the interest period terminates 30 days after filing the form, or on the date assessment is made, whichever is earlier.

Very truly yours,

GEO. J. SCHOENEMAN,
Commissioner,

By GEORGE D. MARTIN,
Internal Revenue Agent in
Charge.

Enclosures: Statement—Form of waiver

Exhibit A—(Continued)

Statement

LA:IT:90D:LHP

Mr. Ernest A. Watson, and Mrs. M. Gladys Watson,
Husband and Wife, Route No. 1, Box 170, Santa
Ana, California.

Tax Liability for the Taxable Year Ended
December 31, 1944

	Deficiency
Income tax	\$24,101.35

This determination of your income tax liability
has been made upon the basis of information on file
in this office.

Adjustments to Net Income

Net income as disclosed by return	\$ 80,573.86
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Additional income:

(a) Income from partnership increased	40,833.33
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Total	\$121,407.19
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Reduction of income:

(b) Net gain from sale or exchange of capital assets decreased	20,416.66
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Net income adjusted	\$100,990.53
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Explanation of Adjustments

(a) and (b) In your return you report a net gain
of \$48,819.82 from the sale of your one-third interest
in an orange grove, 50% of which, or \$24,409.91, you
took into account under the provisions of section
117(j) of the Internal Revenue Code. It has been

Exhibit A—(Continued)

determined that your one-third share of the fair market value of the crop of fruit growing thereon was the amount of \$40,833.33, and that the provisions of section 117(j) of the Internal Revenue Code are not applicable to such portion of the sale price. The amount of \$40,833.33 is therefore added to ordinary income in adjustment (a) and, in adjustment (b), the amount of \$20,416.66 (50% of \$40,833.33) is eliminated from the long-term capital gain of \$24,409.91 reported from such sale.

Computation of Alternative Tax

Net income adjusted.....	\$100,990.53
Less: Excess of net long-term capital gain over net short-term capital loss	3,993.25
Ordinary net income.....	\$ 96,997.28
Less: Surtax exemptions	\$ 1,500.00
Balance (surtax net income).....	\$ 95,497.28
Surtax on \$95,497.28.....	\$ 63,402.63
Ordinary net income.....	\$ 96,997.28
Less: Normal tax exemption.....	875.47
Balance subject to normal tax.....	\$ 96,121.81
Normal tax (3 per cent of \$96,121.81).....	\$ 2,883.65
Partial tax	\$ 66,286.28
Plus: 50 per cent of \$3,993.25.....	1,996.63
Alternative tax	\$ 68,282.91

Computation of Tax

Net income adjusted.....	\$100,990.53
Less: Surtax exemptions.....	1,500.00
Surtax net income.....	\$ 99,490.53

Exhibit A—(Continued)

Computation of Tax—(Continued)

Surtax	\$ 66,876.76
Net income adjusted.....	\$100,990.53
Less: Normal-tax exemption	875.47
Net income subject to normal tax.....	\$100,115.06
Normal tax at 3 per cent.....	3,003.45
Total normal tax and surtax.....	\$ 69,880.21
Alternative tax	\$ 68,282.91
Correct income tax liability.....	\$ 68,282.91
Income tax liability shown on return, account No. 9010202.....	44,181.56
Deficiency of income tax.....	\$ 24,101.35

Received and Filed T.C.U.S. June 1, 1948.

[Title of Tax Court and Cause.]

ANSWER

Comes now the Commissioner of Internal Revenue, respondent above named, by his attorney, Charles Oliphant, Chief Counsel, Bureau of Internal Revenue, and for answer to the petition filed by the above petitioners, admits and denies as follows:

I.

Denies the allegations contained in paragraph I of the petition.

II.

Admits the allegations contained in paragraph II of the petition.

III.

Admits that the tax in controversy is income tax for the taxable year 1944; denies the remaining allegations contained in paragraph III of the petition.

IV.

(A), (B), (C) Denies the allegations of error contained in subparagraphs (A), (B) and (C) of paragraph IV of the petition.

V.

(a) to (e), inclusive. Denies the allegations contained in subparagraphs (a) to (e), inclusive, of paragraph V of the petition.

VI.

Denies generally and specifically each and every allegation in the petition not hereinbefore admitted, qualified or denied.

Wherefore, it is prayed that the Commissioner's determination be approved and the petitioners' appeal denied.

/s/ CHARLES OLIPHANT,

Chief Counsel, Bureau of
Internal Revenue.

Of Counsel:

B. H. NEBLETT,

Division Counsel,

T. M. MATHER,

W. J. McFARLAND,

Special Attorneys,

Bureau of Internal Revenue.

Received and Filed T.C.U.S. July 21, 1948.

[Title of Tax Court and Cause.]

AMENDMENT TO PETITION

The petition in the above entitled proceeding is hereby amended in the following respects:

Paragraph IV of the petition is amended by adding thereto subparagraph (D) to read as follows:

“(D) If the Court determines that a portion of the proceeds received from the sale of said agricultural property, as indicated above, constituted ordinary income and not capital gain, then the respondent erred in not allocating to the sale of the unmatured crop a proportionate part of the selling expenses of \$10,232.50, one-third of which, or \$3,410.83, is allocable to petitioner M. Gladys Watson.”

Paragraph V of the petition is amended by adding thereto subparagraph (f) to read as follows:

“(f) The selling expenses incurred in the sale of said agricultural property amounted to \$10,232.50. If the Court finds that any portion of the total gross sales price of \$197,811.00 is allocable to the growing crop of fruit herein above referred to, and that said proceeds should be treated as ordinary income, then petitioners allege that a portion of said selling expense should also be allocated to said growing crop of fruit in at least the same proportion that the amount of the total gross sales price allocated to said growing crop bears to the total gross sales price.”

Dated December 1, 1949.

A. CALDER MACKAY,
ARTHUR MCGREGOR,
HOWARD W. REYNOLDS,
ADAM Y. BENNION,
JOHN C. MACKAY,
CHARLES J. HIGSON,

/s/ By ARTHUR MCGREGOR,
Counsel for Petitioners.

State of California,
County of Orange—ss.

Ernest A. Watson and M. Gladys Watson, being
duly sworn, say:

That they are the petitioners named in the fore-
going petition; that they have read the said petition
and know the contents thereof; that the same is true
of their own knowledge, except as to those matters
which are stated therein on information or belief,
and as to those matters they believe them to be true.

/s/ ERNEST A. WATSON

/s/ M. GLADYS WATSON

Subscribed and sworn to before me this 1st day of
December, 1949.

/s/ CARL C. COWLES,

Notary Public in and for said County and State

Filed at Hearing T.C.U.S. December 6, 1949.

[Title of Tax Court and Cause.]

ANSWER TO AMENDMENTS TO PETITION

The Commissioner of Internal Revenue, by his attorney, Charles Oliphant, Chief Counsel, Bureau of Internal Revenue, for answer to the amendments to the petition of the above-named taxpayers, admits and denies as follows:

IV.

(D) Denies the allegations contained in subparagraph (D) of paragraph of the amendments to the petition.

V.

(f) Denies the allegations contained in subparagraph (f) of paragraph V of the amendments to the petition.

Denies each and every allegation contained in the amendments to the petition not hereinbefore specifically admitted or denied.

/s/ CHARLES OLIPHANT, E.C.C.

Chief Counsel, Bureau of
Internal Revenue.

Of Counsel:

B. H. NEBLETT,
Division Counsel.

E. C. CROUTER,

A. J. HURLEY,
Special Attorneys,
Bureau of Internal Revenue.

[Title of Tax Court and Cause.]

**FINDINGS OF FACT AND OPINION, AND
DISSENTING OPINION**

Promulgated December 7, 1950

1. The petitioner and her brothers were the operating owners of an orange grove property comprising land, trees, a growing crop of oranges on the trees and other property employed in the operation, which they sold for a lump sum. Held, that the growing crop of oranges was not real property used in the petitioner's trade or business within the meaning of that term as used in section 117(j) of the Internal Revenue Code, and further that the crop constituted property held by petitioner primarily for sale to customers in the ordinary course of her trade or business and the gain realized upon the sale thereof is not under that section to be considered as capital gain.

2. Portion of total selling price allocable to the crop of oranges determined.

3. Held, that a proportional part of the expenses incurred in selling the total properties is to be allocated to the crop.

Arthur McGregor, Esq., and Charles J. Higson, Esq., for the petitioners. A. J. Hurley, Esq., for the respondent.

The respondent determined a deficiency of \$24,-101.35 in the income tax of the petitioners for 1944. The issues are: (1) Whether a portion of the pro-

ceeds received by petitioner, M. Gladys Watson, from the sale of her one-third interest in a citrus grove with the growing fruit thereon is to be allocated to the fruit and regarded as ordinary income, (2) if so, what portion is to be so allocated, and (3) whether the expenses of the sale should also be allocated between the fruit and the other property sold.

FINDINGS OF FACT

A portion of the facts were stipulated and are found accordingly.

At all times material hereto petitioners, Ernest A. Watson and M. Gladys Watson, were married and living together. For 1944 they made a joint income tax return which was filed with the collector for the sixth district of California.

In 1944 Mrs. Watson, sometimes referred to as the petitioner, and her brothers, W. Todd Dofflemyer and Louis L. Dofflemyer, each owned an undivided one-third interest in a 115-acre tract of land consisting of a 110-acre navel orange grove and a 5-acre peach orchard situated near Exeter, Tulare County, California, together with the improvements and equipment thereon. The foregoing land, sometimes hereafter referred to as the Dofflemyer ranch, was acquired about 1912 by the petitioner's father. After the father's death in 1928 the ranch was held by a family holding corporation which was liquidated about the end of 1941 and the property distributed to petitioner and her brothers. As of January 1, 1942, the date of acquisition, they set up the land and im-

provements on their books at an estimated fair market value of \$55,649.44. From and after January 1, 1942, petitioner and her brothers operated the ranch under a partnership agreement. The brothers had supervised or managed the ranch since 1912 or 1913.

About May or June 1944, the petitioner and her brothers listed with H. C. Balaam, a local real estate agent, the Dofflemyer ranch and an 80-acre vineyard with a packing house on it for sale at a lump sum price of \$329,100 for the properties. After attempting to sell the properties Balaam obtained an offer of \$132,000 for the vineyard property. Thereupon petitioner and her brothers withdrew the vineyard from sale and agreed that the asking price for the ranch should be \$197,100, or the difference between the asking price for all the properties and the amount of the offer for the vineyard property. In his efforts to sell the ranch, Balaam, in June 1944, contacted J. W. C. Pogue of Exeter. Pogue had lived in the Exeter vicinity all of his life. He had been the owner of citrus fruit property, and had been in the citrus fruit business since 1907. Since the middle 1920's he had owned property adjacent to the ranch. Before reaching a decision on the matter Pogue desired to wait in order to determine as accurately as possible about what the orange crop would be and also wanted to have petitioner and her brothers bear as much of the production costs of the crop as possible.

Pogue examined the production records of the Dofflemyer ranch for the preceding year broken

down into the various sizes of oranges and the quantity of culls. He went over the property at different times with men from his organization for the purpose of estimating what the orange crop would be. During the first part of August and after having estimated a crop of possibly 80,000 loose boxes of oranges and discounting that amount to 70,000 boxes to be on what he considered the safe side, and after considering orange market conditions current in 1944 and estimating that the proceeds from the orange crop would net about \$120,000 after providing for further cultivation costs, picking, etc., Pogue decided to buy the ranch at the asking price of \$197,100. On August 10, 1944, Louis L. Dofflemeyer who personally had been supervising the ranch since 1913 and was thoroughly familiar with it estimated that the crop of oranges on the trees would produce 70,000 loose boxes. On the same day, August 10, 1944, an agreement was entered into between petitioner, her brothers, and Pogue whereby Pogue agreed to buy the ranch for \$197,100, \$10,000 cash being paid at that time and \$187,100 being payable on or before September 1, 1944. The sellers were to pay all operating costs to September 1, 1944, and taxes and insurance were to be prorated to that date. The proceeds from the peach crop on part of the ranch which was then being harvested went to Pogue who was to bear all expense of harvesting. The growing crop of oranges on the trees also went to Pogue with the land. On or about September 1, 1944, Pogue completed payment for the ranch. In addition he paid \$711 for other property on the premises which had not been

included in the sales contract. The principal reason that Pogue purchased the ranch for \$197,100 and paid all cash therefor was that he estimated he would realize the net amount of \$120,000 from the sale of the orange crop and then would be able to sell the ranch for more than the difference between the purchase price and the proceeds from the sale of the crop. He considered that the selling price of \$197,100 for the ranch with the equipment and the growing crop of oranges was below the market value of the properties.

The following is a statement of the assets included in the sale, the date of acquisition, fair market value at the time of acquisition of assets acquired on January 1, 1942, and the cost of those acquired thereafter, depreciation sustained to date of sale, and depreciated basis at the date of sale:

Assets sold	Date of Acquisition	Basis	Depreciation Sustained	Depreciated Basis
Orange grove:				
110 acres of land*	Jan. 1, 1942	\$21,030.02	\$21,030.02
Trees	Jan. 1, 1942	22,261.03	\$ 8,648.71	13,612.32
Peach orchard:				
5 acres of land*	Jan. 1, 1942	1,000.00	1,000.00
Trees	Jan. 1, 1942	254.12	225.87	28.25
Farm buildings	Jan. 1, 1942	950.00	322.66	627.34
Pipelines (oranges)	Jan. 1, 1942	760.10	405.39	354.71
Disc harrow	Jan. 1, 1942	98.46	65.65	32.81
2 Pumping plants	Jan. 1, 1942	461.02	344.58	116.44
6 Wind machines	Jan. 1, 1942	4,835.12	1,841.20	2,993.92
2 Trucks	Jan. 1, 1942	669.28	446.18	223.10
2 Tractors	Jan. 1, 1942	1,039.44	598.56	440.88
Tractor and equip't	Jan. 1, 1942	1,215.48	810.32	405.16
Ditcher	Jan. 1, 1942	22.68	12.11	10.57
2 Spray rigs	Jan. 1, 1942	792.16	528.13	264.03
Orchard heaters	Jan. 1, 1942	139.65	41.39	98.26
Pump	April 17, 1943	1,230.66	153.87	1,076.79

Assets sold (Cont'd)	Date of Acquisition	Basis	Depreciation Sustained	Depreciated Basis
Oil tank	July 30, 1943	588.60	63.79	524.81
Nursery tank for spray rig	Sept. 7, 1943	152.00	30.39	121.61
Total.....		\$57,620.70	\$14,538.80	\$42,961.02

* Included in the land are pipelines, stands, valves, together with 28.75 inches ditch water rights of the Foothill Ditch Company.

At the time of the sale there were 11,556 trees on the 110-acre grove of navel oranges and 496 trees on the five acres of peach orchard. The orange grove was planted about 1896. It is the oldest grove in the Exeter area and is among the best. The soil is well suited for citrus trees and the ranch has sufficient water available for irrigation. The petitioner and her brothers followed excellent farming methods and practices and the annual per acre production from the grove was about twice the average per acre production for Tulare County. However, many of the trees were affected by a scaly bark condition (a condition different from the scale that gets on the oranges) which eventually necessitates replanting of the trees. Due to improvements made in navel orange stock since the planting of the Dofflemeyer grove the quality of the fruit from that grove was to some extent inferior to oranges produced on younger navel orange groves. The orange trees were planted 20 feet apart which resulted in overlapping of the trees with a consequent disadvantage in cultivating and growing operations compared with groves planted under later practice with trees farther apart.

The following is a statement of the number of loose boxes of oranges produced on the Dofflemyer ranch, gross income received, cultivation and operating expenses, picking and hauling expenses, total expenses, net income and the average of the foregoing items for the years 1934 through 1943:

Year	Loose boxes Produced*	Gross Income	Cultivation and operating Expenses	Picking and hauling Expenses	Total Expenses	Net income or (loss)
1934.....	63,502	\$ 35,986.96	\$ 13,228.29	\$ 5,786.22	\$ 19,014.51	\$ 16,972.45
1935.....	24,461	23,049.54	13,418.80	2,179.10	15,597.90	7,451.64
1936.....	49,653	32,047.16	13,431.90	5,215.30	18,647.20	13,399.96
1937.....	51,031	25,285.97	14,648.46	5,012.32	19,660.78	5,625.15
1938.....	44,907	22,449.23	15,343.72	4,324.22	19,667.94	2,781.29
1939.....	43,443	15,461.14	17,836.55	3,840.43	21,676.98	(6,215.84)
1940.....	60,963	39,910.23	17,126.47	5,423.86	22,550.33	17,359.90
1941.....	78,216	51,606.64	20,268.52	9,241.72	29,510.24	22,096.40
1942.....	54,939	82,521.17	21,163.04	11,568.03	32,731.07	49,790.10
1943.....	79,851	136,808.71	26,217.52	18,438.14	44,655.66	92,153.05
Total.....	550,966	\$465,126.75	\$172,683.27	\$ 71,029.34	\$243,712.61	\$221,414.14
Aver. for 10 yrs.	55,097	46,512.68	17,268.33	7,102.93	24,371.26	22,141.42

* Usually three loose boxes of oranges produce two packed boxes.

The average selling price per loose box of oranges for the 10-year period 1934 through 1943 was 84.42 cents and the average cost per box for picking and hauling for that period was 12.89 cents.

As navel oranges bloom in the spring the small fruit forms on the trees. During May and June, particularly the latter month, a considerable portion of the small fruit thus formed drops from the trees. After that has occurred, usually around July 1 in the Exeter area, the orange crop is said to become "set." Navel oranges in the Exeter area generally mature and are ready for picking early in November. From the time the crop is "set" until it is picked and marketed navel oranges are subject to various types of scale and pests, which, if not controlled, may damage the fruit and render it unmarketable. However, losses from scale and pests on groves which are operated by experienced growers and which receive ordinary care do not present any substantial problem commercially. The Dofflemeyer ranch losses from such sources for 1943 amounted to approximately two per cent of the total crop. Under normal conditions a grove which has generally produced large-sized fruit will produce that type of fruit each year. After the first of September there is little that is likely to happen to the quality of the fruit. It is possible for one experienced in orange growing and familiar with a given grove to estimate with a reasonable degree of certainty during August and Sep-

tember what the production of the grove for the year will be.

The most damaging element to an orange crop in the Exeter area is frost. Generally, the frost period extends from about December 10 to January 15 or 20. In a normal year there are usually a few nights when it is necessary to take some means of protection against frost. Prior to completion of the installation of wind machines on the Dofflemyer ranch, in 1939, frosts were severe enough on an average of once in every four years to cause damage to the orange crop. Thereafter, and until the sale of the ranch in 1944, the wind machines provided protection from the frosts that occurred and no frost damage was sustained. On an average, severe frosts or freezes occur about once in ten years and some damage can be expected despite the use of protective devices on the grove. However, the wind machines and smudge pots on the Dofflemyer ranch were sufficient to provide adequate protection against frost damage except in periods of record-breaking low temperatures of long duration. Usually a large part of the navel orange crop is picked before a damaging frost is normally expected. Under the prorate system, which was in effect in 1944, and under which an orange grove owner picks only an allotted quantity of oranges each week, the period for picking a crop lasts from eight to ten weeks so that some of the matured fruit is exposed to frost risks for a longer time. However, matured oranges are less susceptible to frost damage than unmaturred oranges.

During the frost period of 1944-1945 there was not enough frost to do any damage to the navel orange crop. During the 1948-1949 period the Exeter area experienced the worst freeze in the history of the weather bureau for northern California. That season Pogue did not pick 25 acres of oranges on the Dofflemeyer ranch because of damage from freezing. The last previous freeze occurred in 1937. A factor influencing W. Todd Dofflemeyer to sell the ranch was the possibility of a freeze during the 1944-1945 season, which would render some portion of the then growing orange crop valueless. While there are risks or hazards in the growing of navel oranges, they are no greater in that industry than they are in many other agricultural or fruit-growing operations.

About one-half of the pipelines on the Dofflemeyer ranch were installed during the years 1914 through 1918 and the balance from 1932 to 1937. They were of an old type cement pipeline and had crumbled largely to sand in many places. Although at the time of the sale they were serving the purpose for which they were installed, they were merely a lining in many places and would not withstand heavy tractors passing over them.

The wind machines had been put in during the years 1935 to 1939. They were single type machines and cost about \$2,300 or \$2,400 each at the time of installation. They were in good operating order. The trucks and tractors were all four years old or older. The pump in one of the pumping plants was installed in 1933, while that in the other plant was

installed in 1938. At the time of the sale they were in good condition.

The cost of cultivation in 1944 of the orange crop to September 1 was \$16,020.54, and was taken as an expense deduction by the operating partnership in its return of income for 1944.

During the years 1943 and 1944 the market for oranges was at a very high level with ceiling prices being in effect for the oranges produced in those years. Growers could expect to receive the ceiling price plus premiums under certain conditions for first grade fruit, the ceiling price for the balance of their first grade fruit and some second grade fruit, and an over-all average of near ceiling price for all marketable fruit. The average selling price of the oranges produced on the Dofflemyer ranch in 1943 was \$1.71 per loose box, picking and hauling costs were 23 cents per box, thus indicating a value on the tree at maturity of \$1.48 per box.

Before the prorate system of picking and marketing oranges became effective cash buyers of unmat-
ured and matured orange crops on the trees oper-
ated more extensively than they have since. It was
not uncommon in the Exeter area before the begin-
ning of the prorate system for purchases of unma-
tured orange crops on the trees to be made during
September, and in at least one instance, a purchase
was made as early as July. Because of the large
profits which cash buyers expect to realize from
their purchases owners who sell to them do not re-
alize as much from their crops as if they held them
and sold through consignment organizations. More

than 95 per cent of the orange crops in the Exeter area are marketed through such organizations.

At or about September 1, 1944, Pogue had estimates or appraisals made of the Dofflemyer property by three persons familiar with orange groves values in the Exeter area. On the basis of these and an appraisal made by himself, he allocated on his books \$120,000 of the purchase price of the ranch to the navel orange crop on the trees, \$23,000 to the 115 acres of land, \$38,600 to the 110 acres of orange trees, \$1,000 to the five acres of peach trees, \$6,000 to the wind machines, \$3,000 to the pumping plants, and \$3,000 to the trucks, tractors, etc., on the property.

Beginning in November 1944, the orange crop on the Dofflemyer ranch was harvested, and produced 74,268 loose boxes from which Pogue received gross proceeds of \$146,000. Cultivation costs from September 1 to maturity plus picking and hauling costs amounted to approximately \$20,000, thus resulting in a net return of about \$126,000 from the sale of the crop.

In her joint income tax return the petitioner reported the sale of her one-third interest in Dofflemyer ranch on September 1, 1944, at a net gain of \$48,819.82, fifty per cent of which, or \$24,409.91, was included in taxable income as a long-term capital gain. No portion of the petitioner's one-third share of the selling price of the ranch was allocated to the growing oranges on the trees at the time of the sale. In determining the deficiency here involved

the respondent determined that of the reported net gain of \$48,819.82 from the sale, \$40,833.33 represented petitioner's one-third share of the fair market value of the growing crop of oranges on the trees and that that amount constituted ordinary income and not capital gain.

The expenses of selling the ranch amounted to \$10,232.50 of which the petitioner's one-third share was \$3,410.83. The latter amount was deducted by the petitioner in computing the capital gain reported from the sale.

The portion of the selling price of the Dofflemyer ranch, \$197,100, allocable to the growing crop of oranges on the trees, was \$40,000.

OPINION

Turner, Judge: The question here is what portion, if any, of the gain realized by the petitioner upon the sale of the orange grove property is attributable to the growing crop of oranges then on the trees and, if any portion of the gain is attributable to the oranges, whether under section 117 of the Internal Revenue Code it is, or is to be considered as gain from the sale of capital assets.

That the oranges did not constitute capital assets as capital assets are defined in section 117 is at once apparent, and that is so whether the oranges be regarded as an inseparable part of the trees and therefore real estate used in petitioner's trade or business, as claimed by her, or as property held by the taxpayer primarily for sale to customers in the ordinary course of her trade or business, as claimed

by respondent, since by the specific language of section 117(a) of the Code¹ both real estate used in the trade or business and property held primarily for sale to customers are excluded from the definition of capital assets. It is the claim of the petitioner, however, that section 117(j)² applies, and that if

¹Sec. 117. Capital Gains and Losses.

(a) Definitions.—as used in this chapter—

(1) Capital Assets.—The term “capital assets” means property held by the taxpayer (whether or not connected with his trade or business), but does not include stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business, or property used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 23(1), * * * or real property used in the trade or business of the taxpayer.

²(j) Gains and Losses From Involuntary Conversion and From the Sale or Exchange of Certain Property Used in the Trade or Business.—

(1) Definition of property used in the trade or business.—

For the purposes of this subsection, the term “property used in the trade or business” means property used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 23(1), held for more than 6 months, and real property used in the trade or business, held for more than 6 months, which is not (A) property of a kind which would properly be includible in the inventory of the taxpayer if on hand at the close of the taxable year, or (B) property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business. * * *

(2) General Rule.—If during the taxable year,

any part of the gain from the sale of the property as a whole was properly attributable to the oranges on the trees at the time of sale, it was gain realized from the sale of real estate used by her and her brothers in their business of owning and operating the orange grove property and under that section gain realized from the sale of real property used in a taxpayer's trade or business is to be considered as if it were gain from the sale of a capital asset. In developing this contention, the petitioner argues first that this is a case which turns on the nature and character of property rights and that in such cases state law is controlling, and second, that under California law and the general law of most states, oranges growing on the trees at the time of sale of an orange grove property constitute a part of the real property.

One difficulty with that argument is that there is no hard and fast rule under California law or, so far as we have found, under the law of any state, unless it be Georgia, that a growing crop of oranges or any other growing crop is, or is not, to be regarded as a part of the real estate.

the recognized gains upon sales or exchanges of property used in the trade or business, * * * exceed the recognized losses from such sales, exchanges * * * such gains and losses shall be considered as gains and losses from sales or exchanges of capital assets held for more than 6 months. If such gains do not exceed such losses, such gains and losses shall not be considered as gains and losses from sales or exchanges of capital assets." * * *

The Civil Code of California (Deering 1933) provides as follows:

§658. Definition of real property. Real or immovable property consists of:

1. Land;
2. That which is affixed to land;
3. That which is incidental or appurtenant to land;

4. That which is immovable by law; except that for the purposes of sale, emblements, industrial growing crops and things attached to or forming part of the land, which are agreed to be severed before sale or under the contract of sale, shall be treated as goods and be governed by the provisions of the title of this code regulating the sale of goods.

§659. Land. Land is the solid material of the earth, whatever may be the ingredients of which it is composed, whether soil, rock, or other substance.

§660. Definition of fixtures. A thing is deemed to be affixed to land when it is attached to it by roots, as in the case of trees, vines, or shrubs; * * * except that for the purposes of sale, emblements, industrial growing crops and things attached to or forming part of the land, which are agreed to be severed before sale or under the contract of sale, shall be treated as goods and be governed by the provisions of the title of this code regulating the sale of goods.

Under California law, fruit trees are not growing crops, but the word "crop" includes fruit grown on such trees. *Cottle vs. Spitzer*, 65 Cal. 456, 4 Pac.

435; Story vs. Christin, 14 Cal. (2d) 592, 95 Pac. (2d) 925.

Wilson vs. White, 161 Cal. 453, 119 Pac. 895, involved an action for specific performance brought by the purchaser under a contract of sale of an orange grove with oranges on the trees which oranges the seller had reserved under the terms of the contract. There it was said:

While for some purposes growing crops are considered personal property, it is practically elementary law that, as between the vendor and vendee of real property having a growing crop thereon, such crop constitutes a part of the realty (unless there has been a constructive severance), and in the case of a voluntary conveyance of the land passes to the grantee unless specially reserved by the grantor.

And while there are some authorities holding that an oral exception or reservation of the crop is effective in such a case, the weight of authority as well as the better reasoning are to the effect that, where a writing is essential to the transfer of real property, such a reservation cannot be established by parol to impair the effect of the writing purporting to convey the land without reservation. See 8 Am. & Eng. Ency. of Law (2d Ed.) pp. 303, 306. And this court appears to have committed itself to this doctrine in Fisk vs. Soule, 87 Cal. 313, 25 Pac. 430, where it was substantially said that a written contract for the sale of land which did not contain any reservation of the crops bound the grantor to include the crops in his conveyance, notwithstanding an oral understanding that the crops were not to be

included, "unless corrected on the ground that by mistake it was not in accordance with the agreement actually made." * * * (Emphasis supplied.)

In *Young vs. Bank of California*, 88 Cal. App. (2d) 184, 198 Pac. (2d) 543, a real estate broker sought to collect a commission on a sale of an orchard with the growing crops thereon for \$125,000. In the negotiations the purchaser insisted on purchasing the properties separately, \$57,500 to be paid for the crops and \$67,500 to be paid for the land, in order to comply with Federal income tax regulations covering the payment of income taxes on capital gains, as distinguished from income. Having no written contract with the seller covering the transaction and being faced with the bar of statute of frauds, the broker contended, among other things, that he should be compensated at least for the sale of the growing crops because they did not come under the bar of statute of frauds. In denying his contentions, the court said:

* * * The sale was one transaction. The purchase price was segregated between the land and the growing crops merely to meet the federal regulations regarding income taxes—to show whether the purchase price of the crops should be treated as capital gains or income. But growing crops under our decisions are a part of the realty until severed just as growing timber is part of the land. *Sears vs. Ackerman*, 138 Cal. 583, 72 P. 171; *List vs. Sandell*, 42 Cal. App. 2d 505, 507, 109 P. 2d 376. It is undisputed that throughout all the dealings the parties herein treated the sale of the land and crops as one transaction.

and there is nothing in the record indicating that any one of them would have considered the sale of one without the other. There is no basis upon which appellant can make a segregation of the sale of the crops from the sale of the land and his case must stand or fall upon the basis of a single transaction covering the entire property.

From the foregoing, it appears that under California law, for the purposes of sale, fruit on the trees is part of the realty and passes as such to the purchaser upon a sale of the land and trees unless there is a specific provision to the contrary in the contract of sale.

The respondent contends that the line of decisions of the California courts represented by *Wilson vs. White*, supra, and *Young vs. Bank of California*, supra, holding that growing crops pass as part of the realty upon sale of the latter, is not determinative of whether the orange crop here involved was or was not real property. Relying on certain decisions involving crop mortgages, he takes the position that the instant orange crop was not real property.

Paragraph 2955 of the Civil Code of California provides as follows:

What personal property may be mortgaged. Mortgages may be made upon all growing crops, including grapes and fruit, and upon any and all kinds of personal property, except the following:

1. Personal property not capable of manual delivery;

2. Articles of wearing-apparel and personal adornment;

3. The stock in trade of a merchant.

Subsequent paragraphs of the Code provide for the manner of mortgaging growing crops.

In *Simpson vs. Ferguson*, 112 Cal. 180, 44 Pac. 484, it was contended that the provisions of the Code relating to the mortgaging of growing crops did not establish an exclusive method for that purpose and that a mortgage upon the land, with its rents, issues and profits, gave the mortgagee a valid lien on the growing crops on the land. In rejecting the contention, the court said:

* * * In the first place, we think it quite manifest, from the provisions of the Code in question that the legislature intended thereby to provide an exclusive mode for the mortgaging of growing crops, and intended to declare that for such purposes this species of property shall be regarded as a chattel. There is nothing in the statute to indicate that it was not intended to cover every case of a mortgage given upon that class of property. In the second place, while it is perfectly true that growing crops may be either personal or real property, according to circumstances, and while as suggested by respondent, a mortgage of the land gives a lien upon everything that would pass by a grant of the land, which includes crops growing thereon, it is nevertheless well established that such lien, so far as the growing crops are concerned, is limited in its effect to the

crops growing upon and unsevered from the land at the time of foreclosure. * * *

Congdon vs. G. M. H. Wagner & Sons, 207 Cal. 373, 278 Pac. 863, involved the question of whether a mortgage on a crop of grapes, executed and recorded in accordance with the provisions of Section 2955 et seq. of the Civil Code, affected the title to the land upon which the grapes covered by the mortgage was being grown and constituted a lien or charge on the land. In holding in the negative, the court said:

* * * It has, however, been held consistently by this court that growing crops are personal property (Marshall vs. Ferguson, 23 Cal. 65; Davis vs. McFarlane, 37 Cal. 636, 99 Am. Dec. 340), and that crop mortgages made, executed, and recorded under the provisions of section 2955 et seq. of the Civil Code do not affect in any degree the title to the land upon which the crops covered by said crop mortgage are being grown and that the same do not constitute a lien or charge upon the land. (Simpson vs. Ferguson, 112 Cal. 180, 40 P. 104, 44 P. 484, 53 Am. St. Rep. 201; First Nat. Bank vs. Brashear, 200 Cal. 389, 253 P. 143.) It was also early decided by this court that a growing crop of fruit occupied the same relation to the land as a growing crop of grain, and as fructus industriales was personal property which might properly be subjected to a chattel mortgage. * * *

In addition to the contrariety of views taken by the California courts with respect to the character of growing crops in that state, we find that in Massa-

chusetts they are regarded as chattels, Commonwealth vs. Galatta, 228 Mass. 308, 117 N. E. 343, while, in Arkansas, they are treated as real property if planted by the land owner, but personalty to the land owner if planted by his tenant, Western Union Telegraph Co. vs. Bush, 191 Ark. 1085, 89 S.W. (2d) 723. By statute, in Georgia all crops, matured or unmatured, are personalty. Under the statute the word "crops" includes the fruits and products of all plants, trees and shrubs, whether the same be annual or perennial, and also crude gum from a living tree. Code of Georgia Annotated, Sections 85-1901 and 85-1902. Under such statute, it was held that a growing crop of pecan nuts on the trees was personalty and that the crop did not pass as part of realty by sale and conveyance of the land, Miller vs. Jackson, 190 Ga. 668, 10 S.E. (2d) 35. Haines City Citrus Growers' Association vs. Pette-way, 105 Fla. 135, 145 So. 183, involved the question of whether fruit crops produced on mortgaged land were subject to the real estate mortgage or to a crop mortgage. There the court said:

Growing citrus fruit crops, such as oranges, grapefruit, and tangerines, which essentially owe their annual existence to cultivation and labor, including fertilizing and spraying for control of insects and diseases which attack and injure the fruit, though products of perennial plants or trees, are chattels, while the trees themselves are part of the realty. * * *

A further illustration of the variety of situations involving growing crops and the conflict of views taken with respect thereto appears in Vought vs.

Kanne, 10 Fed. (2d) 747 (CCA 8). The question there was whether a bankrupt's homestead exemption under the laws of Minnesota included the growing grain crops on the homestead. In holding that the exemption did not extend to such crops, the court said:

Growing crops occupy an unique legal position. They spring from and are physically attached to the land, but are intended to be and may be severed therefrom without injury to the land. When so severed there can be no question that they are then personal property. There is some conflict in the different jurisdictions as to whether such crops, while unsevered, are personalty or realty but the great weight of authority is that unsevered annual crops are personalty. 17 C. J. 379, note 5; 8 R. C. L. 356, notes 13 and 14. This was the common-law rule and it has been followed in most of the American Jurisdictions. 23 L. R. A. (N. S.) 1219, note. However, it is hardly correct to say that any jurisdiction, where there are decisions upon different character of transactions affecting growing crops (such as conveyances, statute of frauds, ejectment, trespass, landlord and tenant, execution levy, attachment, inheritance) has held such crops in all instances and as to all transactions to be either personal property or real property. The determination "depends very greatly on the nature of the transaction in which the question arises." * * *

If, then, the above may be regarded as fairly reflecting the law of California and of other states with respect to growing crops and the disposition

thereof, petitioner's argument, in effect, is that since under the California law of conveyancing oranges on the trees pass with and as a part of the real estate unless specifically reserved or excluded, and since petitioner and her brothers sold the entire property without any reservation of the oranges on the trees, that fact determines the character of the oranges and of any gain realized thereon, for the purposes of section 117 of the Internal Revenue Code, and under subsection (j) thereof, the gain must be considered as capital gain. Correspondingly, it would also follow, if that contention is sound, that if the oranges had been separately sold the gain realized therefrom would have been ordinary gain and not within the scope of section 117. In other words, the method or manner of sale or the form which the sale took would be controlling.

In *Helvering vs. Hammel*, 311 U. S. 504, however, it was held that the manner in which a sale was effected was not determinative of whether the resulting loss was a capital loss or an ordinary loss. And in *Burnet vs. Harmel*, 287 U. S. 103, the Supreme Court, pointing out that Congress had enacted the Federal income tax statutes in the exercise of its plenary powers, under the Constitution, to tax income, said:

* * * It is the will of Congress which controls, and the expression of its will in legislation, in the absence of language evidencing a different purpose, is to be interpreted so as to give a uniform application to a nation-wide scheme of taxation. * * * State law may control only when the operation of the

federal taxing act, by express language or necessary implication, makes its own operation dependent upon state law. * * *

The Court there, as here, was concerned with the character of income as capital gain or ordinary gain, and it went on to say that "For the purpose of applying this section to the particular payments now under consideration, the act of Congress has its own criteria, irrespective of any particular characterization of the payments under local law. See *Weiss vs. Wiener*, supra, page 337 of 279 U. S., 49 S. Ct. 337, 73 L. Ed. 720. The state law creates legal interests, but the Federal statute determines when and how they shall be taxed."

Accordingly, the fact that under the law of California the oranges on the trees were or were not to be regarded as real property for the purpose of construing the conveyance and for the purpose of determining and confiding rights as between seller and purchaser does not supply the answer to the question here. To the contrary, the answer must be found in the Federal statute, and a reading of that statute plainly shows that it is not whether property is realty or personalty, or is to be regarded as one or the other for certain purposes or in certain circumstances, which determines whether gain realized from the sale thereof is to be taxed as capital gain, but rather it is the purpose for which the property is acquired or held or the use to which it is put that supplies the answer. Real property may or may not be a capital asset, or it may or may not be an asset the gain from the sale of which is, under

section 117(j), to be considered as capital gain. It must likewise be real estate used by the taxpayer in her trade or business, and not only that, but it must be real estate "which is not * * * (B) property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business." In the circumstances here, it is not enough, therefore, merely to find that the growing crop of oranges was real estate or was to be regarded as real estate under local law. It must also be found that the oranges did not constitute property held primarily for sale to customers in the ordinary course of her trade or business.

That in the instant case the oranges, exclusive of the land, trees and improvements, did in fact constitute a distinct and important item or element in the lump sale, which occurred, is not, in the light of the evidence, now open to question. Petitioner and her brothers, back in May or June, at the time the orange trees were blooming or the blossoms were dropping, had offered the property at the price later obtained, but had received no takers and, as far as we know, no counter offers. Pogue was approached but was not interested until he could determine as accurately as possible the extent of the current crop. He also wanted to avoid, as much as possible, the burden and cost of cultivating the crop. It was only after the oranges had reached the stage at which satisfactory estimates of the crop could be made that a sale was negotiated. During negotiations or at or about the time of the closing of the contract, and for the apparent purpose of having a record of what

was sold, Louis L. Dofflemyer, who had been manager of the grove for many years, made a survey and estimated that the crop on the trees would be approximately 70,000 loose boxes of oranges, normal crop conditions thereafter being granted. The harvest later proved the estimate to be very sound. As far as Pogue was concerned, the quantity and condition of the oranges, plus the price anticipated when the crop should reach maturity, supplied to him the controlling inducement for buying the entire property at the price paid, and for cash. On the basis of his experience that freeze years occurred in cycles, W. Todd Dofflemyer, who negotiated the sale, felt certain that the season of 1944-1945 would be a freeze year and desired to cash in before cold weather, letting the purchaser run the risk of crop loss due to frost. His testimony, in effect, was that if he had not thought there would be a crop loss due to frost, and had thought they would have received ceiling price for the oranges, he would not have sold but would have held the property. In other words, all the parties to the sale did, in fact, regard the oranges as a crop of fruit on the trees, and not as trees or land. Pogue was buying oranges which he planned to harvest and sell to customers. Petitioner and her brothers were selling their crop of oranges for cash in hand, allowing to the purchaser the added revenue if they reached maturity without loss and the high prices continued.

That farmers, fruit growers, and the like regard, think of and deal with their crops, whether growing or mature, as being something apart from or

other than the land itself, is, we think, so generally known and accepted as to require no discussion or amplification here. The crop is their stock in trade and from the time the fruit appears on the plant, vine, or tree, it is thought of in terms of the units by which it is measured for sale and of the anticipated prices per unit. In short, the primary purpose and objective of the farmer or fruit grower is the sale of his crop to some customer or customers. It is, of course, true that in some instances a crop may not be held primarily for sale to customers, but rather for use in processing, developing, or producing some other commodity for marketing, as in the case of corn or other grain grown for the purpose of conversion into beef or pork, which in turn becomes the commodities held primarily for sale to customers. But here we have no such a case.

The petitioner argues, however, that the oranges in this instance were not held primarily for sale to customers in the course of her trade or business, because she and her brothers were in the business of producing and selling ripe oranges and not in the business of producing and selling green oranges. Granting that petitioner and her brothers had never before sold their oranges prior to maturity, that fact in no way negatives the proposition that the oranges were held primarily for sale by them in the ordinary course of their business. It is fundamental, we think, that the grower, all factors being considered, seeks to sell his crop at the time and in the manner he considers to his best advantage, and while the evidence indicates that since the development

of better protective devices against the natural hazards of orange growing and the advent of the compulsory "prorate" method of harvesting oranges, there have been no known sales of crops of oranges prior to maturity in the area in which the property herein was located, we are unable to see how the holding of the oranges primarily for sale to customers is changed to a holding primarily for some other purpose because the grower manages to realize his purpose to sell by making a sale to his liking before the oranges are mature, or because as a part of the same transaction the land was also sold.

On the basis of the picture presented, it is our conclusion, and we hold, that the oranges sold by petitioner and her brothers did not constitute real estate used by them in their trade or business which was "not * * * (B) property held by [them] primarily for sale to customers in the ordinary course of [their] trade or business," and accordingly, the provisions of section 117(j) do not apply.

Petitioner cites and relies on *Albright vs. U. S.*, 173 Fed. (2d) 339; *Fawn Lake Ranch Co.*, 12 T.C. 1139; *Isaac Emerson*, 12 T.C. 875; *Butler Consolidated Coal Co.*, 6 T.C. 183; *Camp Manufacturing Co.*, 3 T.C. 467; and *J. J. Carroll*, 27 B.T.A. 65, aff'd., 70 Fed. (2d) 806. Those cases are distinguishable, and are not controlling here. *Butler Consolidated Coal Company* was the case of a taxpayer engaged in the business of mining coal. The property sold was land from which it had at one time mined coal and which still contained some coal. The mining

operation had been abandoned some eleven years prior to sale of the property and the mine had been allowed to fill with water. It was held that the coal in place was not held primarily for sale to customers in the course of the taxpayer's trade or business. *Camp Manufacturing Company* and *J. J. Carroll* are cases involving the sale of tracts of standing timber by owners who were engaged in the manufacture and sale of lumber. The opinion in each of those cases pointed out that the principal business of the taxpayer was the using of timber in the manufacture of lumber, and not the sale of timber tracts themselves. In the instant case, the petitioner was never engaged in the business of using oranges for the purpose of producing another product. Her business was that of producing oranges for sale to customers. Though the oranges passed through various stages of growth from bloom to maturity, at each stage they were held for one and the same primary purpose, namely, for sale to customers, and never at any stage of operation were the oranges held for or devoted to any other purpose. The *Albright*, *Emerson* and *Fawn Lake Ranch* cases are as to the instant case even more remote. There, the petitioners were in the dairy, livestock or cattle business, and the sales involved were sales of animals culled from breeding and dairy herds. In those cases, the animals in question were not held primarily for sale, but for the purpose of producing the animals and other products which were held primarily for sale. To make those cases comparable to the instant case, it would be necessary for us here to be dealing with

gains realized by petitioner and her brothers from the sale of the orange trees themselves.

Since the orange crop was not a capital asset, the portion of the total selling price allocable thereto is to be treated as an amount received from the sale of a noncapital asset. In determining the deficiency the respondent determined the portion of the total selling price allocable to the orange crop to be \$122,500, and the petitioner's one-third share thereof as \$40,833.33. On brief, he contends that the portion allocable to the crop was not less than \$120,000. The petitioner contends that the allocation of \$10,700 would be reasonable and in no event should such allocation exceed \$16,000.

Each of the parties produced a number of witnesses who gave testimony bearing on the value of the various properties including the orange crop at the time sold. Values expressed for the orange crop ranged from a low of approximately \$4,000 to a high of approximately \$120,000. In general, the values for the orange crop expressed by petitioner's witnesses were substantially below the amount expended to the time of the sale for the production of the crop. On the contrary, they placed substantial values on the other assets included in the sale. The respondent's witnesses, on the other hand, placed much higher values on the crop and substantially lower values on the other assets. The top value now contended for by the petitioner for the orange crop, namely, \$16,000, is approximately the amount expended to the date of the sale in the production of the crop, while the \$120,000 value contended for by the respondent is about \$6,000 less than the net amount realized by

Pogue after he had held the crop to maturity and gathered and sold it. From a consideration of all the evidence bearing on the question, we are of the opinion that the portion of the total selling price properly allocable to the orange crop was \$40,000, and have so found as a fact.

The remaining issue is whether the total selling expenses of \$10,232.50 should be allocated between the crop of oranges and the other assets sold. No such allocation was made by the respondent in determining the deficiency. However, on brief, he concedes that such expenses should be allocated between the crop and the other properties in the proportion that the portion of the total selling price allocable to each bears to the total selling price. Since the respondent's concession disposes of the issue, we hold for the petitioner as to it.

Reviewed by the Court.

Decision will be entered under Rule 50.

Black, J., dissenting: I agree with the majority opinion that what is a capital asset in determining whether the gain from the sale of property shall be taxed as capital gain or as ordinary income depends on statutory definition as written by Congress. It is not governed by state law. Congress, of course, could tax all income from the sale of capital assets as ordinary income if it chose to do so. The term "income" as used in the Constitution and income tax laws has been defined by the Supreme Court as "the gain derived from capital, from labor, or from both

combined, provided it be understood to include profit or gain from a sale or conversion of capital assets." *Stratton's Independence vs. Howbert*, 231 U.S. 399; *Doyle vs. Mitchell Bros.*, 247 U.S. 179; *Eisner vs. Macomber*, 252 U.S. 189. But Congress has elected to provide in section 117 of the Internal Revenue Code that gains from the sale of certain property shall be taxed as long-term capital gains and that only 50 per cent of the gain shall be taken into account for the computation of income tax. Generally the term "capital assets" as defined by Congress includes all classes of property not specifically excluded in the statutory definition. The term is defined in the statute, as follows:

Sec. 117. Capital Gains and Losses.

(a) Definitions.—As used in this chapter—

(1) Capital Assets. —The term "capital assets" means property held by the taxpayer (whether or not connected with his trade or business), but does not include—

(A) stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business;

(B) property, used in his trade or business, of a character which is subject to the allowance for depreciation provided in section 23(1), or real property used in his trade or business;

* * * * *

* * * * *

At the outset, I wish to make it plain that I do not question the feasibility of dividing the sale which

took place here into its component parts. I accept as correct the doctrine in *Williams vs. McGowan*, 152 Fed. (2d) 570, where taxpayer sold a hardware business as a going concern, including accounts receivable, fixtures, and merchandise inventory, that the whole business was not to be treated as a single piece of property representing "capital asset" for income tax purposes, but the sale would be comminuted into its fragments and there would be separately matched against the definition in the statute of capital assets.

It is perfectly clear to me that in the instant case Pogue, the purchaser, bought himself a growing orange crop when he made the purchase here involved. I am also willing to believe that the growing orange crop had a fair market value of \$40,000 at the time of sale and that as found by the majority "The portion of the selling price of the Dofflemeyer ranch, \$197,000; allocable to the growing crop of oranges on the trees, was \$40,000." But that does not, in my opinion, solve the problem which we have here: The problem is whether this growing crop of unmaturred oranges on the trees is excluded from the definition of "capital assets" by the exceptions enumerated in section 117. I do not think they are excluded. Clearly, the immature oranges which were on the trees at the time petitioner sold them were not "stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year" as those terms are used in section 117. Were they "property held by the taxpayer

primarily for sale to customers in the ordinary course of his trade or business" (emphasis supplied) as provided in section 117(a)(1)(A)? If they were, then the majority opinion is correct because its conclusions are based on that particular provision of the statute and the majority has made an affirmative finding that the unmaturing oranges were "property held by the taxpayer primarily for sale in the ordinary course of his trade or business." But I think there is much force in petitioner's contention as stated in the majority opinion, as follows:

The petitioner argues, however, that the oranges in this instance were not held primarily for sale to customers in the course of her trade or business, because she and her brothers were in the business of producing and selling ripe oranges and not in the business of producing and selling green oranges. * * *

Of course, it goes without saying that if a producer of oranges, such as was petitioner in the instant case, sells the oranges on the trees after they have matured the income therefrom would be ordinary income and not capital gain. She would be selling property held primarily for sale to customers in the ordinary course of her trade or business. That business was the growing and selling of ripened oranges. In other words, she would not have to pick them off the trees and sell them after they were picked in order for the income to be taxed as ordinary income. The ordinary income provisions of the statute would be quite as effective in cases of selling fruit matured, still unpicked on the trees, as it would

be in selling the fruit after it was picked—I certainly concede that fact. But where, as here, the land is sold, together with the producing orange trees and the immature oranges on the trees, it seems to me the situation is different. In that sort of a situation the property sold is “real property used in the trade or business of the taxpayer” as used in the last sentence of section 117(a)(1).

If I am correct in this assumption, then section 117(j) is applicable which was added as an amendment by section 151(b) of the 1942 Act. Subsection (j) which was thus added reads, as follows:

(j) **Gains and Losses From Involuntary Conversion and From the Sale or Exchange of Certain Property Used in the Trade or Business.**—

(1) **Definition of property used in the trade or business.**—For the purposes of this subsection, the term “property used in the trade or business” means property used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 23(1), held for more than 6 months, and real property used in the trade or business, held for more than 6 months, which is not (A) property of a kind which would properly be includible in the inventory of the taxpayer if on hand at the close of the taxable year, or (B) property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business, * * *

(2) **General rule.**—If, during the taxable year, the recognized gains upon sales or exchanges of property used in the trade or business, * * * exceed the recog-

nized losses from such sales, exchanges, * * * such gains and losses shall be considered as gains and losses from sales or exchanges of capital assets held for more than 6 months. If such gains do not exceed such losses, such gains and losses shall not be considered as gains and losses from sales or exchanges of capital assets. * * *

If section 117(j) is applicable to the sale of the entire property here, as I think it is, then even though it is possible to divide the sale into component parts as the majority opinion does, petitioner's entire gain from the sale is taxable as long-term capital gain as petitioner contends and the gain from the sale of the unmatured oranges is not ordinary income as the Commissioner has determined and the majority opinion holds.

Of course, it is perfectly true that Congress by appropriate definition could exclude gain from the sale of unmatured crops, such as we have here, from the benefits of the capital gains provisions of the statute, but I do not think it has done so when the statutory definitions and exceptions are given their ordinary and commonly understood meaning.

I would, therefore, sustain petitioner in her contention that the gain from the sale of the unmatured orange crop here involved should be taxed as long-term capital gain and not as ordinary income. I, therefore, respectfully dissent.

Harmon, J., agrees with this dissent.

The Tax Court of the United States
Washington

Docket No. 18856

ERNEST A. WATSON and M. GLADYS
WATSON,

Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

DECISION

Pursuant to the Court's Findings of Fact and Opinion promulgated December 7, 1950, the respondent, on January 23, 1951, having filed a proposed recomputation of the tax involved in accordance therewith, and this proceeding having been called from the motion calendar of February 14, 1951, for settlement under Rule 50, at which time the petitioners offered no objection to the respondent's recomputation, it is:

Ordered and Decided: That there is a deficiency in income tax for the year 1944 in the amount of \$6,920.35.

Entered: February 15, 1951.

[Seal] /s/ BOLON B. TURNER,
Judge.

Served February 16, 1951.

[Title of Tax Court and Cause.]

STIPULATION OF FACTS

It Is Hereby Stipulated and Agreed by and between the parties hereto, by and through their respective counsel, that the following facts shall be taken as true, without prejudice to the right of either party to introduce other and further evidence not inconsistent therewith:

1. At all times material hereto, petitioners, Ernest A. Watson and M. Gladys Watson, were married and lived together as husband and wife, residing at Santa Ana, California.

2. For the year 1944 petitioners filed with the Collector of Internal Revenue for the Sixth District of California, a joint income tax return covering items of income and deductions for both petitioners.

3. During the year 1944 M. Gladys Watson, one of the petitioners herein, owned an undivided one-third interest in certain agricultural land consisting of approximately 110 acres of orange grove and five acres of peach orchard located near Exeter, County of Tulare, State of California, together with improvements and equipment located thereon. During the latter part of the year 1944, said property was sold to one J. W. C. Pogue. The total sales price was \$197,811.00, consisting of \$197,100.00 paid through escrow, and \$711.00 paid outside of escrow for addi-

tional equipment. The expenses of sale were \$10,232.50 and the net proceeds were \$187,578.50. One-third of this amount, or \$62,526.17, was received by petitioner, M. Gladys Watson.

4. Petitioners' son, Donald G. Watson, and his wife, Llewellyn A. Watson, had no interest in the above property which was sold, nor the proceeds, if any, attributable to the unmaturing crop on the trees.

5. At the date of sale the orange trees had on them an unmaturing crop of navel oranges. The peach crop on said property was substantially matured at the date of sale and the proceeds therefrom, amounting to \$1,729.74, were turned over to the purchaser in accordance with the terms of the sale agreement. The cost of cultivation of the crop on the orange grove to the date of sale was \$16,020.54.

6. There is no controversy between the parties herein regarding the adjusted cost basis of the real estate and improvements and equipment which was sold. All of such properties had a total cost basis to petitioners at dates of acquisition in 1942 and 1943 in the amount of \$57,620.70. Depreciation sustained, to the date of sale, amounted to \$14,538.80; leaving depreciated basis of all of such properties in the total amount of \$42,961.32 of which one-third or \$14,330.31 represents the basis to these petitioners in determining the profit on the sale of these properties. This depreciated basis for said properties has been used by the petitioners in their return. The respondent has also used this figure in connection with his de-

termination of the amount of gain and income received from the sale of these properties in 1944.

/s/ CHARLES OLIPHANT ECC
Chief Counsel, Bureau of
Internal Revenue

A. CALDER MACKAY
ARTHUR McGREGOR
HOWARD W. REYNOLDS
ADAM Y. BENNION
JOHN C. MACKAY
CHARLES J. HIGSON

/s/ By ARTHUR McGREGOR,
Counsel for Petitioner

Filed at Hearing T.C.U.S. December 6, 1949.

United States Court of Appeals for the
Ninth Circuit

Tax Court Docket No. 18856

ERNEST A. WATSON and M. GLADYS
WATSON,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION FOR REVIEW OF DECISION OF
THE TAX COURT OF THE UNITED
STATES

To the Honorable Judges of the United States
Court of Appeals for the Ninth Circuit:

Comes now the Petitioners, Ernest A. Watson
and M. Gladys Watson, and respectfully show:

I.

Nature of the Controversy

Respondent determined a deficiency in the income tax liability of petitioners, Ernest A. Watson and M. Gladys Watson, for the calendar year 1944, in the amount of \$24,101.35. Petitioners filed a petition with The Tax Court within the time allowed, and the proceeding was heard at Los Angeles, California, on December 6, 7, 8, and 9, 1949, by the Honorable Bolon B. Turner, Judge of The Tax Court. The Tax Court entered its decision on February 15, 1951, ordering and deciding that there is a deficiency

in income tax for the year 1944 in the amount of \$6,920.35.

The issues presented below were: (1) whether the Commissioner erred in allocating the sales price of an orange grove having immature oranges on the trees, and in treating the part of the sales price allocated to the immature growing oranges as ordinary income and not capital gain; and (2) in the event that an allocation of sales price should be made whether the Commissioner erred in determining the amount to be allocated to the immature oranges.

Petitioner, M. Gladys Watson, during the year 1944 owned an undivided one-third interest in certain agricultural land consisting of approximately 110 acres of orange grove and five acres of peach orchard located near Exeter, Tulare County, California, known as the "Dofflemyer Ranch," together with improvements, water rights and equipment located thereon. Petitioner and her co-tenants acquired this property on December 31, 1941.

On August 10, 1944, Petitioner, M. Gladys Watson, and her co-owners entered into a contract of sale of this agricultural property, together with the improvements, water rights and equipment thereon, for a lump sum consideration of \$197,100.00, of which \$10,000.00 was paid at the time of making the contract and the balance of the purchase price was paid on September 1, 1944.

At the date of the sale the trees of the orange grove had on them immature oranges which would not begin to mature until sometime in November and would be picked during a period of eight to ten weeks thereafter. The oranges bloom in the spring,

and during May and June a considerable portion of the blossoms and fruit drop from the trees. The green oranges "set" on the trees (cease to fall) about July 1, or a little over a month prior to the date of the contract of sale.

The sales agreement did not mention a crop of oranges on the trees, but the sale of the grove was treated as a sale of real property. Documentary stamps were attached to the deed covering the entire amount of the consideration paid for the property. In their agreement, the parties made no allocation of sales price, the property selling as a unit for a lump sum of \$197,100.00.

Petitioner, M. Gladys Watson, and her two brothers operated the property in question under a partnership agreement. The brothers assumed active management of the property, and they had supervised this particular property ever since 1912. The occupation of the partnership and of the individuals was that of farmers and fruit growers. They were not in the business of selling orange groves. Neither were Petitioner, M. Gladys Watson, and her co-tenants engaged in the business of selling immature fruit on the trees, and they had never made such a sale prior to the time the grove in question was sold on August 10, 1944. It was not the practice in the citrus industry in California to sell oranges on the trees prior to maturity.

Petitioners, on their joint income tax return for the year 1944, reported the gain from the sale of the undivided one-third interest in the orange grove as capital gain from the sale of real property used

in the trade or business of the taxpayer held for more than six months, and falling within the purview of Section 117(j) of the Internal Revenue Code.

The Commissioner of Internal Revenue, applying retroactively his ruling issued in 1946 (I.T. 3815, 1946-2 CB 30), determined that of the amount of \$48,819.82 reported as net gain by Petitioner, M. Gladys Watson, from the sale of her one-third interest in the Dofflemyer Ranch, \$40,833.33 thereof represented the sales price of the immature fruit, and that the same constituted ordinary income. This would represent a value of \$122,500.00 which the Commissioner allocated to the immature fruit on the trees out of a total sales price of \$197,100.00 for the Dofflemyer Ranch.

The Tax Court, two judges dissenting, determined that an allocation of the sales price should be made and that the portion of the sales price applied to the immature fruit represented ordinary income. The Court further determined that the portion of the selling price of \$197,100.00 allocable to the growing crop of oranges on the trees was \$40,000.00.

For a sale to result in a capital gain, the property sold must be a "capital asset." The term "capital asset" includes all property not specifically excluded in Section 117(a)(1) of the Internal Revenue Code. Prior to 1942 depreciable property used in the taxpayer's trade or business was excluded. Real property, however, was considered to be a capital asset. Congress desired to place land and depreciable property used in the trade or business in the same category with respect to gains or losses. As a result, the

Revenue Act of 1942 added Section 117(j), which provides that real estate properties, both land and depreciable property, held for more than six months, are to be treated as ordinary assets and not capital assets. Upon the sale of such assets, if there is a gain, it will be treated as a capital gain; but if there is a loss, it may be taken in full as an ordinary loss against other income.

In order for a sale to be given the beneficial treatment of Section 117(j), the taxpayer must show the following facts:

(1) That the entire property sold was "property used in the trade or business;"

(2) That the entire property sold was "real property" or property which is subject to an allowance for depreciation;

(3) That the entire property sold was "held for more than six months" before sale;

(4) That the property sold was not of a kind "which would properly be includible in the inventory of the taxpayer if on hand at the close of the taxable year;"

(5) That the property sold was not "held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business."

The citrus trees and land are clearly Section 117(j) assets. Applying the above provisions to the sale of immature oranges, there is little difficulty in satisfying requirements (1), (3) and (4). Clearly the growing and selling of fruit is a trade or business. The entire property including the oranges had been held for more than six months. The immature fruit

was not property of a kind includible in petitioner's inventory.

With respect to point (2) above it is petitioner's position that the nature and character of property rights as defined by the State law is controlling and that under California law and the general law of most states, oranges growing on the trees at the time of sale of an orange grove property constitute a part of the real property.

With respect to point (5) above it is petitioner's position that the immature oranges were not held primarily for sale to customers in the ordinary course of her trade or business because she and her brothers were in the business of producing and selling ripe oranges and not in the business of selling green, immature oranges. Where the land is sold together with the producing trees which have on them the immature oranges, the situation is different. The property sold then is "real property used in the trade or business of the taxpayer" as outlined in (5) above.

The Petitioners are aggrieved by the Findings of Fact and Opinion of The Tax Court and by its Decision, by reason of the determination that any part of the sale proceeds represented sale of property held by the Petitioner, M. Gladys Watson, primarily for sale to customers in the ordinary course of her trade or business, and further, by its failure to hold that the growing trees and immature fruit constituted a unit with respect to which no separate allocation of sales price could be made to the immature fruit.

The Tax Court erred in failing to determine that

the entire property sold constituted real property used in the trade or business of the taxpayer within the purview of Section 117(j) of the Internal Revenue Code, and it also erred in allocating a portion of the sales price to the growing crop.

II.

Court in Which Review Is Sought

The United States Court of Appeals for the Ninth Circuit is the Court in which review of said decision of The Tax Court is sought pursuant to the provisions of Section 1141 of the Internal Revenue Code.

III.

Venue

Pursuant to Findings of Fact and Opinion promulgated December 7, 1950, the Decision of The Tax Court was entered on February 15, 1951. The Petitioners, Ernest A. Watson and M. Gladys Watson, husband and wife, during the year 1944 and for many years prior thereto and thereafter were residents of the City of Santa Ana, State of California. They filed a joint individual income tax return, Treasury Form 1040, for the calendar year 1944 with the Collector of Internal Revenue for the Sixth District of California, whose office is located at Los Angeles, California, and within the jurisdiction of the United States Court of Appeals for the Ninth Circuit, where this review is sought.

The parties hereto have not stipulated that said decision may be reviewed by any Court of Appeals other than the one herein designated.

Wherefore, Petitioners pray that the Findings of Fact, Opinion, and Decision of The Tax Court be reviewed by the United States Court of Appeals for the Ninth Circuit; that a transcript of the record be prepared in accordance with the law and rules of said Court and transmitted to the Clerk of said Court for filing; and that appropriate action be taken to the end that the errors complained of may be reviewed and corrected by said Court.

Dated: May 9, 1951.

/s/ A. CALDER MACKAY

/s/ ARTHUR MCGREGOR

/s/ HOWARD W. REYNOLDS

/s/ ADAM Y. BENNION

/s/ RICHARD N. MACKAY

/s/ CHARLES J. HIGSON,

Attorneys for Petitioners.

Filed T.C.U.S. May 11, 1951.

[Title of U. S. Court of Appeals and Cause.]

**NOTICE OF FILING PETITION
FOR REVIEW**

To Charles Oliphant, Chief Counsel, Bureau of Internal Revenue, Washington, D. C.:

You are hereby notified that the petitioners on the 11th day of May, 1951, did file with the Clerk of The Tax Court of the United States, at Washington, D. C., a petition for review by the United States

Court of Appeals for the Ninth Circuit of the decision of The Tax Court heretofore rendered in the above-entitled cause. A copy of the petition for review as filed is hereto attached and served upon you.

Dated this 9th day of May, 1951.

/s/ A. CALDER MACKAY

/s/ ARTHUR MCGREGOR

/s/ HOWARD W. REYNOLDS

/s/ ADAM Y. BENNION

/s/ RICHARD N. MACKAY

/s/ CHARLES J. HIGSON

Counsel for Petitioners.

Acknowledgment of Service attached.

Filed T.C.U.S. May 11, 1951.

[Title of U. S. Court of Appeals and Cause.]

STATEMENT OF POINTS AND DESIGNA-
TION OF PARTS OF THE RECORD
TO BE PRINTED

Come Now Ernest A. Watson and M. Gladys Watson, Petitioners on review herein, by their attorneys, A. Calder Mackay, Arthur McGregor, Howard W. Reynolds, Adam Y. Bennion, Richard N. Mackay and Charles J. Higson, and state that the points on which they intend to rely in this case are as follows:

1. The Tax Court erred in holding and deciding

that the immature crop on the trees at the date of sale of petitioner M. Gladys Watson's undivided one-third interest in an orange grove, constituted property held by this petitioner primarily for sale to customers in the ordinary course of her trade or business.

2. The Tax Court erred in holding that any part of the gain realized upon the sale of said orange grove represented ordinary income and not to be treated as capital gain.

3. The Tax Court erred in failing and refusing to hold and decide that under the law of the State of California the entire grove, including the immature fruit on the trees, constituted real property used in the trade or business of the taxpayer, held for more than six months and subject to capital gains treatment under Section 117(j) of the Internal Revenue Code.

4. The Tax Court erred in failing to treat the trees and the immature fruit as inseparable, constituting property of the same nature, and in making a separate allocation of the sales price to the immature fruit.

5. The Tax Court erred in that its opinion and decision are contrary to law.

Petitioner hereby designates the entire record, as certified to the Clerk of the above entitled Court pursuant to Designation of Contents of Record on Review as filed herein, as necessary to be printed for the consideration of the points set forth above.

including this Statement of Points and Designation.

Dated: May 25, 1951.

/s/ A. CALDER MACKAY

/s/ ARTHUR McGREGOR

/s/ HOWARD W. REYNOLDS

/s/ ADAM Y. BENNION

/s/ RICHARD N. MACKAY

/s/ CHARLES J. HIGSON

Attorneys for Petitioners.

Acknowledgment of Service attached.

Filed T.C.U.S. May 28, 1951.

[Title of U. S. Court of Appeals and Cause.]

DESIGNATION OF CONTENTS OF RECORD ON REVIEW

To the Clerk of The Tax Court of the United States:

Come Now the Petitioners on review herein, by their attorneys, A. Calder Mackay, Arthur McGregor, Howard W. Reynolds, Adam Y. Bennion, Richard N. Mackay and Charles J. Higson, and hereby designate for inclusion in the record on review in the above entitled proceeding all matters required by Rule 75(g) of the Federal Rules of Civil Procedure, including the following:

1. Docket entries of the proceedings before The Tax Court.

2. Pleadings:

(a) Petition, including annexed copy of deficiency notice.

(b) Answer.

(c) Amendment to Petition.

(d) Answer to Amendments to Petition.

3. Findings of Fact and Opinion, and Dissenting Opinion promulgated December 7, 1950.

4. Decision entered February 15, 1951.

5. Stipulation of Facts.

6. From the official report of hearing before The Tax Court on December 6, 7, 8 and 9, the following pages:

(a) Testimony of W. Todd Dofflemyer, commencing on page 9, line 17; pages 10, 11, 12 and 13; page 19; pages 40, 41, 42, 43, 44, 45, and first line of 46; 77; 80, 81, 82, 83, 84, 85, 86, 87, 88, 89, 90 and 91; 370, 371, 372; 375, 376, 377.

(b) Testimony of Wiley D. Ambrose on pages 135, 136, 137; 150 and 151.

(c) Testimony of R. B. Wallace on pages 220, 221, 222, 223, 224, 225, 226 and 227; 232, 233 and 234.

(d) Testimony of J. W. C. Pogue on pages 262; 347, 348, 349, 350; 353.

(e) Testimony of L. L. Dofflemyer on pages 394, 395; 403, 404; 421.

(f) Testimony of Jack M. Dungan on pages 479; 484, 485.

7. Petitioners' Exhibit Nos. 2 and 5.

8. Petition for Review and Notice of Filing Petition for Review.

9. Statement of Points and Designation of Parts of the Record to be Printed.

10. This Designation of Contents of Record on Review.

Wherefore, it is requested that copies of the record as above designated be prepared and transmitted to

the United States Court of Appeals for the Ninth Circuit in accordance with the rules of said Court.

Dated: May 25, 1951.

/s/ A. CALDER MACKAY

/s/ ARTHUR McGREGOR

/s/ HOWARD W. REYNOLDS

/s/ ADAM Y. BENNION

/s/ RICHARD N. MACKAY

/s/ CHAREES J. HIGSON

Attorneys for Petitioners

Acknowledgment of Service attached.

Filed T.C.U.S. May 28, 1951.

[Title of U. S. Court of Appeals and Cause.]

SUPPLEMENTAL DESIGNATION OF RECORD ON REVIEW

To the Clerk of The Tax Court of the United States:

You are hereby requested to prepare, certify, transmit and deliver to the Clerk of the United States Court of Appeals for the Ninth Circuit certified copies of the following documents in addition to those requested by petitioners on review.

1. The complete transcript of the hearing of this proceeding held in Los Angeles on December 6, 7, 8 and 9, 1949, including all exhibits introduced in evidence.

2. This Supplemental Designation.

/s/ CHARLES OLIPHANT,

Chief Counsel, Bureau of Internal Revenue, Counsel for Respondent on Review.

Acknowledgment of Service attached.

Filed T.C.U.S. June 5, 1951.

The Tax Court of the United States
Washington

[Title of Cause.]

CERTIFICATE

I, Victor S. Mersch, Clerk of The Tax Court of the United States, do hereby certify that the foregoing documents, 1 to 15, inclusive, constitute and are all of the original papers and proceedings on file in my office as called for by the "Designation of Contents of Record on Review and Supplemental Designation of Record on Review", in the proceeding before The Tax Court of the United States entitled "Ernest A. Watson and M. Gladys Watson, Petitioner, vs. Commissioner of Internal Revenue, Respondent, Docket No. 18856; and in which the petitioner in The Tax Court proceeding has initiated an appeal as above numbered and entitled, together with a true copy of the docket entries in said Tax Court proceeding, as the same appear in the official docket book in my office.

In testimony whereof, I hereunto set my hand and affix the seal of The Tax Court of the United States, at Washington, in the District of Columbia, this 6th day of June, 1951.

[Seal] /s/ VICTOR S. MERSCH,
Clerk, The Tax Court of the
United States.

[Title of Tax Court and Cause.]

TRANSCRIPT OF TESTIMONY

Mr. McGregor: Call Mr. W. Todd Dofflemyer.

W. TODD DOFFLEMYER

was sworn and testified as follows:

The Clerk: State your name and address, please.

The Witness: W. Todd Dofflemyer, and my address is RFD 1, Box 72, Exeter, California.

Direct Examination

Q. (By Mr. McGregor): Mr. Dofflemyer what is your occupation?

A. I am supposed to be a rancher, fruit grower, packer.

Q. And your present occupation as such? [9]

A. The same.

Q. And that was your occupation during 1944 at the time of the sale of the Dofflemyer ranch?

A. Yes.

Q. How many years have you been engaged in such occupation?

A. Well I have been engaged in the orange business practically all my life, or in this particular place I started in about 1912.

Q. You are talking of the 110 acres you sold in 1944?

A. Yes. I continued until it was sold in 1944.

Q. During 1944 you were operating the ranch under a partnership agreement, I believe?

A. That's right.

Q. What was the name of that partnership?

(Testimony of W. Todd Dofflemyer.)

A. T. J. Dofflemyer and Sons partnership.

Q. And who were the partners?

A. The partners were my brother—and Louis Dofflemyer, and my sister Mrs. Watson.

Q. The petitioner in this case?

A. That's right.

Q. And yourself?

A. And myself, yes.

Q. And what were the activities of the T. J. Dofflemyer and Sons partnership?

A. T. J. Dofflemyer and Sons operated the property, this [10] 110 acres, and 5 acres of peaches and about 80 acres of grapes which was owned as tenants in common by the same party.

Q. The partnership then did not cover the ownership of the property but just operated it; is that right?

A. That's right. They were an operating concern exclusively.

Q. Who kept the books and records of the operations?

A. I did.

Q. Do you have them here in court?

A. Yes.

Q. I show you a compilation. Would you identify it and tell the court what it is?

A. This is a compilation prepared from the books and shows the book value of the assets. I see that is the date—I think it's the date of the sale. That doesn't necessarily mean that there aren't some other assets. This is the book value of the assets on the property at that time.

(Testimony of W. Todd Dofflemyer.)

Q. Well, at the bottom it says, "Note: Included in the land are pipelines, stands, valves, together with 28.75 inches ditch water rights of the Foothill Ditch Company." Those assets were not on the books?

A. That's right. Also some three other assets.

Mr. McGregor: I would like to offer this as Petitioner's Exhibit 2.

Mr. Hurley: If the court please, I would like to ask [11] the witness a question. Mr. Dofflemyer, when was this tabulation prepared?

The Witness: Oh, the tabulation? I don't know just when the tabulation was prepared, but that's a record from the books itself.

Mr. Hurley: Did you personally make it?

The Witness: Yes.

Mr. Hurley: Was it prepared recently?

The Witness: No—quite a while ago—probably at the end of the year. In other words, we generally have to make those up every year for filing for income tax purposes. I think that was made at the end of the year. I don't know just when.

Mr. Hurley: Did the note that you have on the bottom of the tabulation appear on the original?

The Witness: No, that was on there originally, this is—

Mr. Hurley: I understand that but I am speaking of the tabulation—in the note which appeared at the bottom of the tabulation—was that placed on there recently—does it appear on the books or just—

(Testimony of W. Todd Dofflemyer.)

• The Witness: No, it doesn't appear on the books. I stated that.

The Court: Do you mean was it put on that tabulation recently?

Mr. Hurley: Yes, that is my question. [12]

The Court: In other words, was that note originally on the tabulation, or was it put on that copy there?

The Witness: I imagine it was put on this copy.

Mr. Hurley: Did you put it on there?

The Witness: I testified that it was on there.

Mr. Hurley: Who personally wrote the note that appears on the bottom of the exhibit.

The Witness: I think I dictated it.

Mr. Hurley: And when did you do that?

The Witness: I wouldn't know exactly the time.

Mr. Hurley: In 1944 or '45?

The Witness: Well, I wouldn't say that definitely; no.

Mr. Hurley: No objection, your Honor.

The Court: It may be received and marked as Petitioner's Exhibit 2.

The Clerk: Admitted in evidence.

(The document above-referred to was received in evidence and marked Petitioner's Exhibit 2.)

Q. (By Mr. McGregor): Mr. Dofflemyer, I show you a compilation of figures. Will you identify that and tell the court what it is?

A. Yes, this is a ten-year record of production, income and expenses, with average prices of the orange

(Testimony of W. Todd Dofflemyer.)

grove sold to Mr. Pogue in 1944, and I might state that the word "cultivation" [13] —it might be a little bit misleading. It might be broadened to include cultural costs including all costs. The 4th column, strictly speaking means all cultural costs.

The Court: Maybe you had better amplify that a little.

The Witness: It means cultivation and irrigation and tree care and fumigating and all the other costs that go with that. The word "cultivation" was just used there as a sort of a heading; that is all. However, it means all cultural costs. (14)

* * * * *

Q. (By Mr. McGregor): Mr. Dofflemyer, will you identify this document?

A. This is the escrow agreement, or a copy of the escrow agreement, dated August 10, 1944, wherein the Dofflemyers sell to one J. W. C. Pogue this 110 acres of oranges and 5 acres of peaches together with wind machines and equipment and everything.

Mr. McGregor: This does not seem to be signed by Mr. Pogue, but I think there is no objection to that; is that right?

The Witness: I think the original was signed.

Mr. McGregor: I would like to offer this in evidence if no objections.

Mr. Hurley: No objections.

The Court: It may be marked in evidence as Petitioner's Exhibit 5.

The Clerk: Admitted in evidence.

(Testimony of W. Todd Dofflemyer.)

(The document above-referred to was received in evidence and marked Petitioner's Exhibit 5.)

Q. (By Mr. McGregor): Mr. Dofflemyer, I show you a photostat of some computations of measurements. Will you identify it?

A. Yes. This is a picture of the—or a map of the property that was sold. On this map it shows the pipelines and the diameter of the pipelines and their location, the number of stands and valves, gates, and things of that kind. [19]

* * *

Q. Now this Downing ranch is the one, I take it, that is marked in Exhibit 8 and drawn with red pencil and marked "B"—is that right? [39]

A. That's right. That's the Downing Ranch. That was distributed to Mr. Cobb.

Q. And the ranch was sold about the same time when your ranch was, of 110 acres, that went to Mr. Pogue?

A. That's right.

Q. In the escrow of August 10, 1944?

A. It was also sold to Mr. Pogue at about the same time.

Q. That is during August of 1944?

A. That's right.

Q. And you know what price the Downing Ranch was sold to Mr. Pogue for?

A. Well, I don't know exactly, but I heard it was \$185,000.00.

Q. Now, Mr. Dofflemyer, when the 110 acre orange orchard was sold to Mr. Pogue, will you state when the fruit was set, if you can, on the trees?

(Testimony of W. Todd Dofflemyer.)

A. Well, I think the fruit—we call it set about July 1st—sometime in July, possibly.

The Court: What do you mean by “set”?

The Witness: We mean by that after the June drop is over.

The Court: The June what?

The Witness: The June drop.

The Court: What do you mean by “drop”?

The Witness: In other words, when the oranges blossom in the spring there's lots of blossoms on the trees and lots of little fruit set on the trees, and then during June, sometimes in May, weather conditions cause a big percentage of these to drop off, and we call that the June drop.

The Court: Sounds like growing cotton down in the delta country.

The Witness: I don't know anything about cotton but probably the bolls would drop the cotton the same way.

The Court: To some extent.

The Witness: But, of course, I have seen the June drop extend after the 1st of July, sometimes in the middle of July.

The Court: Depends upon conditions?

The Witness: That's right.

The Court: That is somewhat comparable to the cotton except that in cotton mostly it drops off when it is in bud—in bloom.

The Witness: Of course, a lot of these do too, when they are in bloom.

Q. (By Mr. McGregor): When the fruit sets, I

(Testimony of W. Todd Dofflemyer.)

take it that is from the period of time that if there is any value it would be from that period, is th. it right?

A. Well, the value, of course, is there all the time, but you don't know just what it is. It might be nothing—it might be something. Just for purposes of argument you might [41] say the fruit is set on July 1st, but that's about all you can say. Now, what value it would have on July 1st—that's just problematical.

Q. When does the fruit become mature?

A. Fruit becomes mature when it passes the test.

Q. We are talking about the 110 acres that was sold.

A. The fruit—any kind of fruit—would not be matured until it passes the maturity test.

Q. Well, when would that be?

A. That would be anywhere in that particular grove from about the 1st of December to about the 15th of January.

Q. Now you say it would have to pass a certain test. What do you mean by that?

A. The maturity test is what we call it. It is the eight to one test—eight parts of soluble solids to one part of acid and it also has to have a 25% characteristic orange color before they are allowed to be picked.

Q. Who establishes that test?

A. It is established by the state.

Q. Under state laws you cannot sell fruit unless it qualified on that test, is that right?

A. That's right. You might be able to go and pick a few oranges off that particular grove before that

(Testimony of W. Todd Dofflemyer.)

time by climbing to the tops of the trees and getting a few of the oranges that are out there in the sun and which mature a little [42] earlier than the general average.

Q. Now upon this orange grove are all the oranges picked at one picking or are there two or three pickings?

A. Well, until it becomes generally mature we always used to pick them on several pickings over the tops of the trees first, and on the outside where the sun would shine on them. Wherever the sun was they would seem to mature a little earlier, and a little later, when they became mature all through the tree, we would pick the whole tree at once.

Q. In other words, under the leafy part would not mature as fast?

A. Usually, yes.

Q. How many pickings do you have?

A. Generally two pickings—sometimes three.

Q. In your experience, Mr. Dofflemyer, what percent of maturity would you say the oranges were upon the 110 acres that were sold to Mr. Pogue on August 10, when the contract was entered into?

A. Well, just figuring roughly I would say they would be about 15% matured.

Q. How do you figure that?

A. Well, I would figure maturity at a rather accelerated rate. I would figure it at about 10% for July, and then accelerate it at 5% for each month, including November, see, for five months, then I

(Testimony of W. Todd Dofflemyer.)

would say that they would be matured [43] possibly on the first of December.

Q. In other words, you would say they would mature about 10% in July? A. That's right.

Q. To the extent of 25% in August?

A. No, 15% in August.

Q. Well the 15 and 10 that makes 25%. And by the first of September they would be 25% matured. And then October?

A. And in October I would increase it—no, September would be 20%. You see, you increase it each month by 5% because they grow faster and, in other words, they are getting closer to the time of harvest.

Q. And the risk is less, is that it?

A. I wouldn't say the risk is less. The prevailing risks are getting greater all the time. Your fruit can get up to 70% mature and then you can lose it.

The Court: Do I understand what you mean by the percentage of maturity? Is it the rate of development towards maturity from the date you fix as having the fruit set, namely, from the first of July?

The Witness: That's right.

The Court: All right.

Q. (By Mr. McGregor): And you apply this testimony, I take it, to the 110 acres of oranges that were sold to Mr. Pogue? [44] A. That's right.

Q. Now when are the oranges picked, usually?

A. Well they are picked under a maturity test—they have to be ripe. Then they have to have a pro-rate—they are picked under what we call the Pro-rate Act and whereby only a certain amount can be

(Testimony of W. Todd Dofflemyer.)

picked in certain given periods and that period extends from the date of maturity, which would be about the 1st of December on this particular grove—for other groves it would be a little bit earlier—until along about the 1st of February. I think that was the case in that particular year, now—I think it's stretched out even to the 1st of March.

Q. And then they are sent to the packing house and packed, is that right? A. That's right.

Q. And how long do they keep them in the packing house?

A. They are kept in the packing house about an average of five days.

Q. And then they are shipped to the market?

A. That's right.

Q. When do you know what you are going to get for the crop?

A. Well, you don't know until after the fruit is sold in the east what you are going to get for the crop. For any particular orange or any box of oranges you don't know at all what you are going to get. It's just sold on a delivered [45] basis, and the price changes every day.

* * * * *

Q. (By Mr. McGregor): Mr. Dofflemyer, in respect to the freeze of the oranges, how often do you have a freeze in Exeter?

A. Well, what we'd call a freeze—I imagine about every ten years we'd have a freeze, and that's a freeze what I mean that you can't do much about it. Our average on that grove shows frost damage on the aver-

3 (Testimony of W. Todd Dofflemyer.)

age of about every four years from 1913 up to the time when we disposed of it.

Q. Would you like to label the years that you have had frost damage?

A. I think I could, but if we could take an average of every four years—

Q. Well that is the damage that is had beyond the control that you have had with wind machines and smudge pots, is that right?

A. Yes, that's right. In other words, frost damage—we ought to take care of minor damage. In other words, in the spring we might have a frost and we ought to take care of that with the ordinary equipment we have at the present time, but when it comes to a hard freeze it's pretty hard to take care of it with anything. It just gets too cold.

Q. What was the last freeze immediately prior to the date that you sold the 110 acres to Mr. Pogue?

A. I believe it was 1937. [77]

* * * * *

Q. Now, Mr. Dofflemyer, I would like you to explain to the Court how the oranges are marketed. Are most of the oranges in your grove of the 110 acres here, as well as your other oranges in Exeter, marketed through the California Fruit Exchange or its subsidiaries?

A. Most of them are marketed through the Southern California Fruit Growers Exchange or Mutual Orange Distributors.

Q. Will you describe to the Court the process of getting your money out of that organization?

(Testimony of W. Todd Dofflemyer.)

A. Well, ordinarily the fruit is handled through an association which is a member, a marketing group in this particular case, called Central California Citrus Exchange, and this exchange in turn is a member of the group called The California Fruit Exchange, and the California Fruit Exchange sells the fruit. The packing houses—in other words, you first take the orange, pick it off the trees, deliver it to the packing house. The packing house then will sweat the fruit. That means color it. Then they prepare it for market, size it, wrap it, box it, put it in the car, and then it's shipped.

Q. Pre-cool it? [80]

A. Sometimes, if it is necessary. If the weather is warm they will pre-cool it and if it is not warm they will pre-cool it in transit and they will ship it east.

Q. Do you know what you are going to get when you ship it?

A. Oh, No. You ship it east and you turn it over to the California Fruit Exchange, and they will sell it for you.

Q. I take it the California Fruit Exchange is a non-profit exchange?

A. That's right. They sell it for the best price they can obtain in the eastern markets and you don't know what you are going to get for that fruit. You might guess right and then again you might guess wrong. In fact, most of the time we always guess wrong.

The Court: You would not be like the man digging potatoes, and the fellow asked him what he was doing

(Testimony of W. Todd Dofflemyer.)

and he said, "Digging potatoes," and the fellow said, "Did you make a good crop?" And he said, "I don't know. I didn't make as many as I thought I would, but I didn't figure on making anything anyhow." You do not have that attitude, do you?

The Witness: We always hope we'll get a good price, but we never know until the fruit is harvested. Then, after the fruit is sold in the east the money is returned by the Exchange, by the selling agent, to the packing house where it then is pooled with all the other fruit that is sold. So [81] even after you get the sale of your fruit back there, you still don't know what you are going to get for it until the rest of the fruit is sold too.

Q. (By Mr. McGregor): How late is that?

A. That might be pretty late, depending how much you get in the later pools and how the packing house operates their pooling system. Sometimes they operate the pooling system under a season pool and I think that's becoming more prevalent than any other way, and if it is a season pool you wouldn't know what you were going to get exactly until the last case was in, which might be along in March.

The Court: Do you mean by that that certain fruit that goes into the packing house from all of these groves would go in a pool and then it would be moved to market over a period of time and sold over a period of time, and if the price varied on the early, as compared with the middle shipments or the last shipments, why they wait until the whole pool is disposed of and then prorate it—prorate the average price, is that the way it is done?

(Testimony of W. Todd Dofflemyer.)

The Witness: That's right—most of them are.

The Court: In other words, the price that the grower gets is the average price on the pool?

The Witness: That's right.

The Court: Regardless of whether his might have brought a greater or lesser amount? [82]

The Witness: That's right.

Q. (By Mr. McGregor): And how were the oranges on the 110 acres that you sold to Mr. Pogue marketed—under a pool system?

A. Well, Mr. Pogue has his own operating system, but the same principle would apply. He wouldn't know what he was going to get for his average until his last car was sold.

Q. Has he got a pool system that he markets his crop under?

A. I couldn't know. He has his own packing organization, and I didn't think it would be necessary to have a pool, but still the same thing would apply, because his would be the average of all the oranges that went into the packing house. Whether he keeps one grove separate from another grove, I wouldn't know that.

Q. And you say that 75% of the oranges in Tulare County are marketed under the California Fruit Growers Exchange or subsidiaries?

A. That I think is right.

Q. And about 10% through the Mutual Orchards Association, is that right?

A. About 10 to 12, I'm not exactly sure.

(Testimony of W. Todd Dofflemyer.)

Q. And Mr. Pogue markets his oranges the same way?

A. No, Mr. Pogue markets his through the California Fruit Growers Exchange. [83]

Q. He has the same question of establishing what he is going to get for the oranges?

A. Yes, he has.

The Court: Do I understand you, though, that he operated in a way so that he set up his own pool.

The Witness: That's right. He's a packing house entity in himself and he is a member of the California Central Fruit Growers Exchange. I think he handles only his own fruit.

Q. (By Mr. McGregor): Now, Mr. Dofflemyer, when did you put this 110 acres of orange orchard and the five acres of peach orchard up for sale?

A. I believe it was along in May 1944.

Q. And who did you list it with?

A. Mr. Balaam.

Q. And is he a real estate broker in Exeter?

A. Yes.

Q. He is in court here now, is he?

A. Yes, he is. I see him over there.

Q. And when he sold the orange orchard and the peach orchards under the agreement of August 10, 1944 did you reduce the price over that which you listed it in May?

A. We didn't change the price any.

Q. In other words, you sold the orchard for exactly the same price as you offered it in May of 1944, is that right?

(Testimony of W. Todd Dofflemyer.)

A. That's right—in May 1944. We also offered the [84] vineyard, but in August 1944 we withdrew the vineyard from the market.

Q. I see. Now when you discussed the terms of the agreement to sell, did you have any oral or written allocation of any amount of the sale price to any particular asset that was sold? A. No.

Q. You placed—

A. I want to qualify that. We did sell—I think it was some oil and some ladders and, I think, a little truck.

Q. That was the qualification we made this morning, that about \$700.00 worth of assets were sold out of escrow. Other than those 2 items, there was no allocation of any particular part of the sales price which you agreed to allocate to any particular asset?

A. That's right.

Q. Would you explain to the Court the reasons for selling the grove?

A. Well, of course I was influenced possibly by the fact that there might be a freeze at that particular time. My son was in Europe with the Army. D-Day had just happened in June 1944. He was somewhere on the continent—I didn't know where. I felt pretty low at the time. And all those factors together—my brother was feeling pretty badly at the time—he was a really sick man and he had been taking care [85] and operating the grove at that particular time and he just said he couldn't do it any longer, and I had my nephew up there and he didn't get along with my brother, and the thing was a continual source of

(Testimony of W. Todd Dofflemyer.)

worry to us. And while the market looked like it was pretty good we felt, well the best thing to do is sell it before we let it deteriorate, and go back. If we can't take care of it, and help was hard to get and we didn't know from one time to another that we were going to get any help at all, and I thought the best thing to do was to sell it now, if we can do so.

Q. Mr. Balaam also sold the Cobb & Dofflemyer Ranch; the Downing Ranch, at that time?

A. That's right.

Q. You have an opinion as to what should be allocated for the unmaturred oranges at the date of sale, do you not?

A. Well, you mean as to just what they were worth?

Q. The fair market value, if anything, that the oranges were worth, any time between August 10th and September 1st.

A. Well, that's a hard question to answer, but if you got to have it, I'll try it.

Q. Well, there is potential value there, is there not?

A. Yes, I think so.

Q. What would you say was the value of it?

A. I would suggest that possibly the cost of the oranges from the first of the year, from January 1, 1944 to the date [86] of sale, August 10, 1944, might be considered the fair market value of the oranges at that time regardless of the amount of oranges on the trees.

Q. And that cost of cultivation to the time the grove was sold was how much?

(Testimony of W. Todd Dofflemyer.)

A. Around \$16,000.00.

Mr. McGregor: If your Honor please, we have already stipulated that in the record this morning and I think that was the question that you had asked about, this morning, as to what the grove had cost to cultivate up to the time of sale.

The Court: No, I did not ask any question about it. I just merely observed that part of what was shown on those figures, I mean on that tabulation, for the other years was likewise proper for 1944. I did not ask any questions.

Q. (By Mr. McGregor): Now the peach orchard of five acres, Mr. Dofflemyer, it was agreed that you would finish picking the crop? I imagine they were ready for picking at the time of sale, is that right?

A. They were mature and ready to pick.

Q. And did you pick them under the agreement and turn over the money to Mr. Pogue?

A.. Yes, we did.

Q. And how much did you turn over to Mr. Pogue for the sale of those peaches? [87]

A. As I remember it was about \$1,700.00.

Mr. McGregor: It is stipulated in the record, \$1,729.74.

A.. Do you want to know—you asked me another question here a while back about the valuation of the oranges, and I gave you one way I might value them. Do you want to know another way? Well, we could evaluate in another way by taking the average for ten years and establishing the percentage of maturity at the time of sale—the average price received for ten years.

(Testimony of W. Todd Dofflemyer.)

Q. And the production for ten years?

A. Well, the average price would be reflected in the production. And to take that as a basic figure, then you could take the percentage of maturity, multiply that by the average over the ten years—the average price received—then multiply that by the estimated crop and you should have the fair market value at the time of the sale. That would be another way of figuring it.

Q. And on that basis would you venture an opinion as to what the value of the unmaturing oranges were at the date of the sale?

A. I imagine it would be about \$125.00 an acre, possibly—\$100.00 an acre, possibly.

Q. By the way, how much did it cost to produce the peaches that were sold up to the date of sale? [88]

A. As near as I can remember, about \$3,000.00. Possibly it was a little bit more than that.

Q. Does the figure of \$3,107.04 appear right?

A. That's—seems to be correct.

Q. Mr. Dofflemyer, you state that you based your opinion upon the evidence that is already in the record of the sales during the past ten years, the production, and the elements of risk, and the other factors that were testified to, is that right?

A. Now what is that question again?

Mr. McGregor: Mr. Reporter, will you read the last question?

(Last question was read by the reporter.)

The Witness: Yes, that's correct.

(Testimony of W. Todd Dofflemyer.)

Q. (By Mr. McGregor): Mr. Dofflemyer, did you ever inventory unmaturred oranges on the trees?

A. Did I ever inventory them?

Q. Yes, sir. A. No.

Q. Do you know of anybody that ever did?

A. No.

Q. You would say they are not inventoriable property, is that right?

A. No, I wouldn't consider them so.

Q. And, I take it, that you do hold unmaturred oranges [89] for sale to customers in the usual trade of business?

A. No.

Q. Could they be sold—unmaturred oranges?

A. No, it would be against the law.

The Court: What do you mean it would be against the law?

The Witness: Well; an orange has to be matured before it can be crated and be offered for sale in the market.

The Court: Well, what do you mean by crating them and selling in the market?

The Witness: Well, that's the way we sell them.

The Court: Yes, that is the way you sell ripe oranges, but you could sell a crop on the trees, could you not? That is if you could find a buyer?

The Witness: Yes.

The Court: The law would not prohibit that, would it?

The Witness: No.

Q. (By Mr. McGregor): You do not know of any sales of oranges on trees, do you?

(Testimony of W. Todd Dofflemyer.)

A. Oh, yes. There's been sales made in the past—not too many—very few sales are made on the trees.

Q. Do you know what price is paid for the immature oranges, if there have been sales?

A. That varies a great deal. It could be a small price; [90] it could be a large price, depending on the willingness of the buyer to purchase oranges on the trees. In other words, if he saw a particular crop and he liked that particular quality and he wanted to do something with them, why he might purchase them on the trees. But under the present regulations that is not generally done, because of the fact that he also has to have prorated, and he can only ship a certain portion of those oranges that he might purchase on the trees in a certain given time, and ordinarily when a man purchases oranges on the trees he wants to be assured that he can ship those oranges when he wants to ship them, where he wants to ship them, and get any price that he can for them. In other words, he's practically got them sold to somebody that wants them at a particular time.

Q. Do you know of any sales of immature oranges of comparable groves as of August 10 or September 1st?

A. No, I never heard of any oranges being sold on the trees that early.

Q. Mr. Dofflemyer, do you know what is the usual return expected by an orange grower or orchardist on his investment in the orange industry or citrus industry—how much return on your investment would be expected?

(Testimony of W. Todd Dofflemyer.)

A. Well, of course, they get whatever they can, and I don't think it can be hardly reduced to a return on the investment, but ordinarily, in my experience, I figure that a person should be entitled to about 10% on the investment over [91] a period of years, considering the risks involved—I believe that 10% on a fair market value would be a reasonable allocation. They don't always get that, you understand.

* * * * *

[92]

WILEY D. AMBROSE

was sworn and testified as follows:

The Clerk: Will you state your full name and address, please.

The Witness: Wiley D. Ambrose, 156 South "C" Street, Exeter.

Direct Examination

Q. (By Mr. McGregor): How long have you lived in Exeter, Mr. Ambrose? A. Since 1922.

Q. Will you state your education?

A. I am an alumnus of the University of California at Los Angeles. I also spent one year at the University of Southern California.

Q. Did you specialize in any particular studies at those institutions?

A. Yes, I specialized at the University of California in Education—at the University of Southern California in law. [135]

Q. And any other schools?

A. No other schools, except courses that I had taken by correspondence.

Q. Did you take any agricultural studies?

(Testimony of Wiley D. Ambrose.)

A. Oh, yes. I had taken a number of courses through the Extension Division at the University of California.

Q. Particularly with reference to citrus lands?

A. No, I can't say that, but what I have done is this: I've been in the—I've been growing oranges for 27 years, and during all of that period I have read various bulletins and magazines and all the information that I could get. I have always—I have also attended many meetings where the matter of citrus was discussed and have tried to keep up to date on citrus.

Q. You were employed at one time by the Agricultural Department—was that for the state—you were employed at one time by the Department of Agriculture for the Spreckle Sugar Company?

A. That is correct. I was employed by the Spreckle Sugar Company before I came to Exeter.

Q. Was that through the Department of Agriculture for the state or for the Federal Government?

A. I was employed directly by the company itself.

Q. I see. That is in their Department of Agriculture?
A. Yes. [136]

Q. Of Spreckle Sugar Company? A. Yes.

Q. You were also employed in the California Fruit Exchange?

A. California Fruit Exchange, which is a deciduous organization with headquarters in Sacramento. I was field man for them for a period of ten years and then for about another eight years I acted as a packing house manager.

(Testimony of Wiley D. Ambrose.)

Q. You have also been employed for the State of California on the State Highway Department, is that right?

A. Yes, I've been, from 1933 until 1943, a period of about ten years. I was employed under the Division of Contracts and Rights of Way as an appraiser and a right-of-way agent.

The Court: Let me ask a question. You say you were employed by this California Fruit Exchange for how long?

The Witness: A period of ten years.

The Court: What did you do?

The Witness: I was a field man for them a part of the time, and the other portion of the time I managed a packing house.

The Court: What do you mean by a "field man"?

The Witness: Well, I went out and interviewed growers and signed up contracts with growers.

The Court: Interviewed them about what? [137]

The Witness: The interviewing was to get them to become members of the California Fruit Exchange, and I also advised them about the growing of fruit and the handling of fruit.

* * * * *

[138]

Q. Will you state them to the court?

A. In the first place, you are asking me to place a valuation on some orange trees for just one year.

Q. Yes, unmaturred oranges on the tree as of August 10, 1944.

A. I have given you the rule that I would use. I would say that that is about what a buyer going and

(Testimony of Wiley D. Ambrose.)

looking at the grove and seeing the immature fruit there would pay for it, but also a buyer would have this thing in mind particularly: In buying a grove you have in mind what the income will be through a period of ten years or fifteen years or twenty years. Here is a possible income for only one year and it might be possible that this would be the very year that you might have one of those very hard frosts that we have up there, and you not only would be out not only your expense of cultivation, you would be out your expense of protection by heaters and by wind machines and all other expenses in connection with them.

Q. In other words, the risks of the business, is that right?

A. The risks of the business are too vague to place an evaluation for just the one year. It would be just as risky if you went out to Santa Anita and there were ten horses running and you picked out one horse. I don't think it's any more risky than that. [150]

The Court: Would you not change that and say that you picked out one horse and instead of betting him across the board, you bet him on the nose?

The Witness: I'll agree with the court on that.

Q. (By Mr. McGregor): Mr. Ambrose, would you venture an opinion as to what the percent of maturity the oranges were as of August 10 on this 110 acres of orange grove that was sold to Mr. Pogue?

A. As of August 10?

Q. August 10, 1944.

A. I would say somewhere between 10 and 15%—

(Testimony of Wiley D. Ambrose.)

somewhere between 10 and 15%. My dates—the reason for the difference between my dates—the difference between my testimony and Mr. Dofflemeyer's testimony is this: Because I say the date of the setting of the crop is as of July 15 rather than as of July 1, because you usually have quite a bit of June drop during July.

Q. You say 15% mature?

A. Yes. 10 to 15%—in there.

Q. Would you accelerate the maturity as the crop got near to being ready for picking?

A. I think I would—yes, sir. Yes, I'd add about 5% to that each year.

Q. Five per cent each month?

A. Each month, I should say. [151]

* * * * *

R. B. WALLACE

called as a witness for and on behalf of the petitioners, having been first duly sworn, was examined and testified as follows:

Direct Examination

By Mr. McGregor:

Q. Mr. Wallace, will you state your occupation?

A. Sales Manager of Orange and Grapefruit Sales for the California Fruit Growers Exchange.

Q. Will you give us your education?

A. Business education?

Q. Yes; scholastic training.

A. I graduated from high school and business college. Then I went to work in 1913 in the citrus business in Riverside, California.

(Testimony of R. B. Wallace)

Q. Since 1913 what have you done?

A. Well—

Q. Along the citrus growing industry.

A. For four or five years I worked in Riverside. My father was a grower and I worked in the office of a packing house; then went into the sales office of what was termed at that time the Riverside-Arlington Heights Fruit Exchange. [220]

Q. What year was that?

A. About 1914.

Q. How long did you work for them?

A. About four years.

Q. What were your duties?

A. Assisting in the sale of fruit produced in that area.

After that I went to Upland, was Assistant Manager of what is called the O.K. Fruit Exchange located in Upland, which handles the sale of fruit to the California Fruit Growers Exchange in the area of Upland, Cucamonga and that area.

Q. Give us the years.

A. Roughly, from about 1919 to 1922.

Q. Continue.

A. From Upland I went to the Orange County Fruit Exchange at Orange.

Q. What were your duties there?

A. Assistant Manager of Orange County Fruit Exchange. Two or three years there and I came into the Los Angeles office of the California Fruit Growers Exchange about 1924, '25.

Q. Have you been with them ever since?

(Testimony of R. B. Wallace)

A. Yes, sir.

Q. What has been your position in the California Fruit Growers Exchange? [221]

A. Well, the last seven or eight years I have been Orange Sales Manager. Prior to that time I was Assistant Orange Sales Manager during my period in the Los Angeles office.

Q. Can you tell the court approximately what per cent of the oranges produced in California are marketed through the California Fruit Growers Exchange, your organization?

A. I would say, roughly, around 73, 75 per cent; something like that.

Q. Do you know how the rest of it is marketed?

A. Well, there are two or three marketing organizations that have sales facilities all over the country, such as the Mutual Orange Distributors and the American Fruit—

Q. How much do they distribute?

A. Mutual Orange Distributors I would say around 12 per cent. Then there is the American Fruit Growers that of the California crop have possibly 5 or 6 per cent; something like that. Then, in addition to that, there are several individual operators who handle their sales through brokerage arrangements or some such sales arrangement as that.

Q. A very small percentage; is that right?

A. Yes.

Q. Would you estimate?

A. Possibly the group of them would be around 10 per cent. [222]

(Testimony of R. B. Wallace).

Q. Does your organization, or do you through your organization, ever buy an orange crop on the trees? A. No, sir.

Q. Do you know whether any of the rest of them do?

A. You mean individuals connected with our organization?

Q. Yes. No, I mean the other distributors or independent marketers.

A. Some of these so-called independents may be so-called cash operators. In other words, they buy crops from producers.

Q. Do you know any of them that do that?

A. I know that they do do it, yes.

Q. Buy the unmaturing crop on the tree?

A. No, no.

Q. How do they buy the crop?

A. Well, I know of—even a person in the business of buying crops, to supplement his volume—to my knowledge they do not buy crops until the crops are mature and ready for harvest.

Q. Will you tell the court exactly how the California Fruit Growers Exchange market the crop?

A. Well, we maintain sales offices in the principal cities of the United States and sell to the distributing trade through those sales offices at cost, and it very—well, I might say—I might explain first: I don't know if [223] you are familiar—At the start of the season we estimate our costs and deduct or set what is called a "retainer" to cover our expenses. Then at the end of the year we refund the difference between the cost

(Testimony of R. B. Wallace)

of our expenses and the deduction that was set at the beginning of the season.

Q. On the marketing, then, of a crop, when does the grower know how much he is to get for his crop?

A. After the crop is sold.

Q. When is that?

A. Well, different individual packing houses marketing through the Exchange have different what we call "pooling systems." They may have short pools which might run for a period of two weeks, or they might have what would be termed a "season" pool; or you might have variations in between those two extremes.

Q. All right. Now, explain a short pool. What does that mean?

A. Some shippers have what you might call a "pre-season pool." In other words, as the crop comes in to maturity certain growers' fruit would meet the maturity requirements, where other growers' fruit, or the average of the association, wouldn't meet those requirements; so they have operated on the basis of what is termed a pre-season pool, we will say, and that pool would be for just a short period until the crop was generally mature. [224]

Q. Then, after the pool is completed——

A. Well, after the final car in the pool is shipped, you might say, you would have to allow 10 or 12 days for transit to market. Then you might have to wait a week or 10 days for collection of the money; then have to be transported to California. So, roughly, I would say that after the pool is closed it might be 30

(Testimony of R. B. Wallace)

days before the grower would know what he got for his fruit.

Q. You are acquainted with the orange lands in and around Exeter, California, are you?

A. I have visited there, yes.

Q. Do you market the product of the fruit that is grown on what is known as the Dofflemeyer ranch? 110 acres sold by the Dofflemeyer family in August or September 1 of 1944 to J. W. C. Pogue? Did you handle any of that crop in 1944?

A. I presume Mr. Pogue is a member of our organization and I presume that fruit we shipped through the Rocky Hill Association. I have no definite knowledge, but I assume that would be correct because he does market his fruit through the Exchange.

Q. The Rocky Hill Corporation is a member of the Exchange, too?

The Court: You will have to speak the answer vocally because we don't get the nod in.

The Witness: Yes. [225]

By Mr. McGregor:

Q. Now, Mr. Wallace, with your experience in the fruit industry can you estimate the selling price of oranges, say, three months prior to their maturity?

A. No, I could not.

Q. Why do you say that?

A. Well, there are several reasons. In the first place, there is a lot can happen to a crop as it comes into maturity, either because of weather conditions beyond control of the grower, such as extreme heat-

(Testimony of R. B. Wallace)

waves as we have had. We are subject to pests that can lower the quality of the fruit. That is, it might appear to be very good quality at one time, and if it was affected by a pest a month or six weeks before marketing, it could very materially lower the quality of the fruit.

Also, weather conditions and the amount of moisture would have a great bearing on the size that the individual oranges might attain, which in turn might have an effect on the value of the oranges. Those are factors that affect this crop.

Then, in addition to that you have, you might say, national factors such as competition from other citrus-producing areas that you have no definite knowledge as to what time their crops will mature, how rapidly they will ship them to market; and while you might have some information as to other competition such as apples or bananas, or those things, [226] in addition to all those factors you still have the reception of the housewife as to what she is going to decide to spend her money for and how much she is going to pay.

In other words, you can have a coal strike or a lot of industrial strife that would materially lower your buying power. Things might look good the first of October, and the first of December they might not look nearly so good.

Q. I ask you about three months prior. Would you say the same conditions exist two months prior, or one month prior to maturity?

A. Well, as you get closer to the actual time when

(Testimony of R. B. Wallace)

the fruit will be ready to harvest, I would say that your hazards are reduced to some extent, but there are still hazards there. For instance, an orange that isn't fully mature can be damaged by what you might term—well, let's put it this way: It can be damaged by temperatures that more mature oranges wouldn't be affected by. In other words, the more mature an orange is, the colder and longer duration of those temperatures it can stand. So, as you approach the marketing period you reduce the hazards, the hazards of grade being lowered by pests of one sort or another.

Q. Would the market be any more stable at that time?

A. Well, you might have a better idea of the market, but not a whole lot on the market. I would say that you would know more about your fruit quality and size, and that sort of [227] thing, but your market you wouldn't know about.

* * * * *

By Mr. McGregor:

Q. Mr. Wallace, will you state to the court if it is possible on or about August 20 or September 1 of any particular year on a naval orange grove to estimate with any degree of accuracy the kind or the grade and the size of oranges that might be produced on those trees?

A. You could guess, but I wouldn't say it would be necessarily with any degree of accuracy because adverse weather conditions would retard growth, or favorable weather conditions would enhance growth as the crop comes into maturity.

(Testimony of R. B. Wallace)

Q. You would say that the orange did have value, though, as of August 10 or 20?

A. Certainly, but what it would be, I don't know.

Q. Would you give an opinion as to what per cent of maturity on August 10 the oranges would reach?

A. Well—

Q. I am talking about 110 acres of the Dofflemyer ranch sold to Mr. Pogue in Exeter, California, on August 10. That is, escrow was entered into August 10 and completed September 1st.

The Court: Navel oranges.

The Witness: Well, on August 10 you would assume that on the average you would be beyond the so-called June drop by [232] about, say, 30 days. The oranges, you understand, wouldn't be mature. I don't know that it is the right phrase to say it is immature, because it isn't mature until it's mature, but it has reached a very small part of its development, let's say—the development it would reach before its maturity. In other words, your growth rate would be more rapid in the later period, and that would give you a better clue as to whether the fruit was going to be a better size.

There are plenty of hazards in the way of leaf hopper and thrips, and that sort of thing, that could injure the quality after that time. In other words, there are still a lot of hazards to be encountered.

Q. Will you express an opinion as to what per cent of maturity the fruit would reach as of August 10 or September 1, then, generally, in Tulare County or in and around Exeter?

(Testimony of R. B. Wallace)

A. I would say somewhere around 15 per cent.

Q. Mr. Wallace, I would like to ask you what, in your opinion, then, would the fair market value be of oranges on a grove on August 10, 1944, where the average production of the 110-acre orange grove shows 55,000 loose boxes of oranges produced over the 10-year period. That is, the average.

The lowest production was in 1935, of 24,461 boxes, as compared to the highest production in 1943 of 79,800 boxes, which was sold for an average price over the 10-year period of .7153. Seventy-one and a half cents-plus per box. [233]

Would you express your opinion now upon that value of the growing crop as of August 10 or September 1, 1944?

A. Well, it would just have to be—I don't know of any crops purchased or sold on that date in commercial practice. It would have to be purely an arbitrary estimate as to—it would be very much of an estimate. I would say that you might allocate 15 per cent or so, and figure you would be safe.

Q. You mean 15 per cent of seventy-one and a half cents per average per box?

A. Business just isn't done that way. I don't know of crops being sold or bought until crops come into maturity.

* * * * *

[234]

J. W. C. POGUE

called as a witness for and on behalf of the respondent, having been first duly sworn, was examined and testified as follows:

(Testimony of J. W. C. Pogue.)

The Clerk: State your name and address, please.

The Witness: J. W. C. Pogue, Exeter, California.

Direct Examination

Q. (By Mr. Hurley): Where do you live, Mr. Pogue?

A. About a mile east of Exeter.

Q. How long have you lived in the vicinity of Exeter?

A. Well, practically all of my life with the exception of six years.

Q. Where were you born?

A. In Tulare County, and Visalia; then I lived at Lemon Cove.

Q. How far is Visalia from Exeter?

A. About eight miles.

Q. How much from Lemon Cove to Exeter?

A. About twelve miles.

Q. You have lived in the vicinity of Exeter all your life; is that correct?

A. That is correct. [262]

* * * * *

Q. And the consignment organization would never take, or you could never estimate until the fruit is ready and ripe, ready for picking; is that right?

A. No. They could estimate; due estimate. It is common practice with all packing houses to estimate their crops in advance of the shipping season to order their shook, order their paper; and that sort of thing.

Q. Now, Mr. Pogue, you have not answered my question yet as to what in your opinion the maturity of the fruit was on August 10 or September 1, 1944.

A. All I can tell you is the cost of producing that

(Testimony of J. W. C. Pogue.)

fruit was practically over, and the quality could be estimated reasonably accurate.

Q. Will you answer my question? What, in your opinion, was the percentage of maturity as of August 10?

A. Well, I don't know what you mean by "percentage of maturity." That crop had been in the process of being produced for over eight months.

Q. You said it was in the process of being produced over eight months?

A. That is right.

Q. What months are those?

A. Starting when you get the crop off, we will say, in [347] December or January; and by the first of September you have had eight months toward the development and production of another crop.

Q. Isn't it the usual course to say that you don't have a crop until the crop is set after the June drop?

A. Well, I don't know what you mean by saying, "the usual course." You cannot determine with any accuracy what your crop will be until after the June drop.

Q. All right. After the June drop—when does the June drop take place?

A. Largely in the month of June.

Q. When do the oranges set?

A. The first part of July.

Q. Up to August 10, then, what percentage of maturity would you say from July 1 to August 10 the fruit had maturity?

A. Well, I would figure it from the first of the

(Testimony of J. W. C. Pogue.)

year, Mr. McGregor, that your crop is at least, Oh, 65 to 70 per cent produced.

Q. Why would you say from the first of the year?

A. That is when your expenses start to produce that crop.

Q. Haven't you taken care of them ten or twenty years prior? You don't know whether the cultivation for the crop ten years prior to that might be going into this crop, do you? [348]

A. Well, we try to reduce things to a crop-year basis and work on a crop-year basis; and that is what I thought you wanted.

Q. No. I want to know what percentage of maturity these oranges were as of August 10, considering the fruit is mature, say, in December when it is ready for picking. Is that when you say it would be mature?

A. No. I said that fruit is picked sometimes in the latter part of October and first part of November.

Q. I will ask you the average of all the fruit that is picked—when do they mature?

A. The average maturity date would be sometime in the early part of November, and then if you had the prorate, and if things were right, you could pick the whole crop.

Q. Then they continue to mature after November and up to December, and possibly over into January until they are actually picked?

A. They are actually picked sometime in November.

Q. Six per cent are picked in November?

(Testimony of J. W. C. Pogue.)

A. In that particular year. Some years it would be—

Q. We are talking about 1944. We want to know the value of that maturity—the percentage of maturity the oranges were on the Dofflemyer Grove on August 10.

A. Oranges are mature when they test 8 to 1, and those oranges probably tested 8 to 1 in that year in about the [349] middle of November, probably uniformly. The year before, 1943—if my memory is correct—they started to pick on that grove, according to Mr. Dofflemyer's record, on November 3. When an orange tests 8 to 1, it is considered mature by the standardization laws of the State of California.

Q. You only picked 6 per cent in November in 1944?

A. That figure is with reference to all of our shipments to the Rocky Hill Association, Citrus Association. That is not necessarily the figure that would apply to the Dofflemyer Grove.

Q. Did you pick more on the Dofflemyer Grove, than you did on any of the other properties?

A. No, I wouldn't say that. It is probably about the same.

Q. About the same?

A. Yes, probably; maybe a little bit less until the latter part of November, and I am not sure as to when we—what dates we delivered the fruit on Mr. Merchant's house, the M.O.D., but probably in the latter or middle part of November.

Q. You mean 6 per cent?

(Testimony of J. W. C. Pogue.)

A. No, that wouldn't be the 6 per cent. That would be in addition to the 6 per cent, because the fruit that went to Mr. Merchant's house was not in the figures that you have here at all. That was merely the Rocky Hill Citrus [350] Association. [351]

* * * * *

Q. Well, you took a chance in 1949 when you sold the Dofflemyer Ranch; didn't you?

A. 1949? That is this year.

Q. When you sold it.

A. The crop you are referring to is the 1948 crop?

Q. That is right.

A. There was some considerable damage because we were late in picking and it was a very unusual year, as anybody in the country will know.

Q. How much of the crop did you lose?

A. Oh, about 25 acres, I expect, that we didn't pick. However, a part of that was our own fault because we could have picked more if we had worked it right.

The Court: At this point, how much more do we have here?

Mr. McGregor: Well, I don't know. I think that—there are one or two more questions that I would like to ask, and then I will be through, your Honor.

The Court: How much do you have?

Mr. Hurley: I have just two or three questions.

By Mr. McGregor:

Q. Mr. Pogue, could you tell in August or Sep-

(Testimony of J. W. C. Pouge)

tember 1, 1944, what kind of fruit, as to quality as well as the size, that you were going to get?

A. You couldn't tell too accurately, no, but you do, knowing a grove over a period of years—you do have an idea [353] that is fairly good as to whether the size will run large or whether it will run small on that particular place.

Under normal care, normal conditions, a grove that has large-sized fruit generally will have large-sized fruit each year; one that has small-sized fruit will have small-sized fruit generally each year. That is, smaller than the average.

As far as quality is concerned, there is really not a whole lot that can happen to the quality of an orange after the first of September.

As far as these scales and that sort of thing attacking the orange, that is not a problem commercially at all if the place is commercially clean. [354]

* * * * *

W. TODD DOFFLEMYER

recalled as a witness for and on behalf of the petitioners, having been previously duly sworn, was examined and testified further as follows:

Direct Examination

By Mr. McGregor:

* * * * *

Q. Was the fruit comparable, or what would you say about that?

A. I believe that the fruit on the Downing grove was a little better quality.

—(Testimony of W. Todd Dofflemyer.)

Q. Did you get a better price on it or how much better?

A. We didn't always get any better price, but we did get a better grade, which would make it a better price in the long run.

Q. But in the final analysis, per acre, you would receive about seventy-five per cent more on the Dofflemyer Navel oranges as you would from the Downing ranch Navels, that is per acre?

A. That has been the past experience, that is right.

In other words, I get about twenty-five per cent more in money per acre than I would off the Downing Ranch.

Q. Mr. Dofflemyer, do you know of any sales of unmaturred fruit on the trees in Exeter district or as a matter of fact, any district in California?

A. I don't know of any sales of unmaturred fruit on the trees, though I have heard of sales of matured fruit being made on trees, and sometimes being made wherein the purchaser would agree to take some of the fruit off of the trees when they became matured, but the purchaser didn't always assume the risk there. In other words, lots of times [370] the growers assumed the risk.

Q. Do you have any information or knowledge of what happened to those buyers that have bought fruit, even matured fruit, on the trees, on a cash basis before they were picked?

Mr. Hurley: I object to that. I think the question

(Testimony of W. Todd Defflemyer.)

is improper and calls for a conclusion and pure hearsay.

Mr. McGregor: I asked him if he knew, Counsel. He can say yes or no.

The Court: I don't know if I understand the question, read the question.

(Question read.)

The Court: What do you mean, what happened?

Mr. Hurley: What buyers?

Mr. McGregor: Those that bought fruit on the trees at any time, even when they were mature, on a cash basis before they were sold.

The Court: Let's be a little more definite. I assume you mean what happened to them with respect to some purchases; whether they made money or lost money?

Mr. McGregor: That is right. Did they make money, or lose money, or go broke?

Mr. Hurley: Ask the witness if he knows?

The Court: I don't know. I don't want any generalized statements. If he can specify some instances, and give some showing that he does have proper knowledge of it. [371]

By Mr. McGregor:

Q. Do you have any instances in which buyers did buy mature fruit upon the trees?

A. I know of one man who bought fruit and he paid \$1.00 a box for it delivered to the packing house. He bought eight thousand boxes and he told me that he got \$8.00 in return for it.

(Testimony of W. Todd Dofflemyer.)

Q. I see. Well, do you know of any other buyers along that line?

A. Well, I know of lots of other general instances, but to be very specific, I wouldn't be able to tell you, Mr. McGregor; as a general rule if they follow the practice, sooner or later they get into trouble. I don't know of any cash operator who has been able to continue cash buying and still be solvent.

Q. You would say then it was absolutely a long chance, is that right?

A. Sometimes they win and sometimes they lose. But in the end they lose. In other words, you just can't tell.

Q. Mr. Dofflemyer, when the Dofflemyer Ranch, orange orchard was sold, were the pipe lines in bad, good, or excellent repair?

A. The pipe lines were in good repair.

Q. And how long would you think, in your opinion, they would last; the life of the grove or some other period of time, [372] or what?

A. Well, it has a very definite life. They have a long life. I will put it that way. Probably from fifteen to twenty years. [373]

* * * * *

Q. All right. Mr. Dofflemyer, you identified and there [374] were introduced into evidence several exhibits having to do with sales by you of certain parcels of land to the Irrigation District, is that right?

A. No, to the Bryant Kern Canal of the Central Valley Water Project. They call themselves so many names.

(Testimony of W. Todd Dofflemeyer.)

Q. How much property was sold to them in 1948; in the 1948 sale? A. 1947.

Q. Excuse me.

A. Three and two-tenths acres.

Q. And how about the 1949 sale?

A. That was a small piece; one-tenth of an acre.

Q. And did you, in both instances, secure any severance damages from the state or the canal authority for taking that property?

A. The severance damage is included in that.

Q. In the damage award, is that right?

A. That is right.

Q. You said a moment ago that it was your opinion that sooner or later cash buyers of fruit get into trouble. Sometimes they win, sometimes they lose, but in the end they lose. A. That is right.

Q. That is an opinion of yours?

A. No, that is a fact.

Q. A fact? [375]

A. Yes, sir.

Q. Do you know the financial statements and conditions of all the cash buyers in Tulare County, or ones that have bought for cash?

A. I have heard a good many of them, and they come into the picture and go out of the picture broke.

Q. The practice of cash buying has more or less come into disuse in recent years, is that correct?

A. That is right.

Q. Does the pro rate system have anything to do with the fact that cash buying today isn't as prevalent as it used to be?

(Testimony of W. Todd Dofflemyer.)

A. I believe it has some effect.

Q. Will you explain briefly just what effect it has?

A. Well, in the past, the cash buyer might buy for some particular house in say, Chicago, for delivery on a certain particular date of a certain amount of fruit, when it reaches maturity, and they would be willing to pay a certain price.

For instance, they wanted it for the Christmas trade or holidays. That would be very difficult to do at the present time because of the allocation of the fruit.

In other words, the fruit is under a pro rate and they could only ship a certain amount of that particular fruit at that particular time, and that would discourage any cash [376] buyer from going out and buying that. But that didn't take away the hazard of the market and things of that kind, because lots of times the cash buyer loses on the market.

In other words, he might start out from here with his dollar or dollar and a quarter fruit and get back there and find it is fifty cents.

Q. In other words, the cash buyer is very much in the same position as any trader on the grain market, that buys grain futures?

A. That is right.

Q. Sometimes he wins, and sometimes he loses?

A. Yes, but in this particular case, sooner or later they lose.

Q. That is your opinion?

A. That is the truth.

(Testimony of W. Todd Dofflemyer.)

Q. Mr. Dofflemyer, as to these pipe lines and irrigation ditches, pumping stations, and the like on the property, what was your estimated useful life of those assets for depreciation purposes?

A. For depreciation purposes, I think we set them up as 17 years; some of them may be 10 years.

Q. At the date of sale in 1944 of the Dofflemyer ranch to Mr. Pogue, all of those assets were actually depreciated on the books?

A. No, there were still some on there. I think we have [377] them on there. [378]

* * * * *

LOUIS L. DOFFLEMYER,

called as a witness for and on behalf of the Petitioner, having been previously duly sworn, was examined and testified as follows:

The Clerk: State your name and address for the record.

The Witness: My name is Louis L. Dofflemyer, Exeter, Tulare County, California.

Direct Examination

By Mr. Higson:

Q. What is your occupation, Mr. Dofflemyer?

A. My occupation is rancher, supervision of groves of [394] the Dofflemyer partnership, and also of my own personal groves.

Q. Then how long have you been in the business of orange grower?

A. I have been in the orange growing business since 1913.

Q. Have you continuously been in that business?

(Testimony of Louis L. Dofflemeyer.)

A. Except 1945, 1946, and part of '47, when I was sick in the hospital.

Q. And do you own any orange groves up and around the vicinity of Exeter?

A. I do. I own twenty acres of Navels about a mile north of Exeter and about three miles north-east of Exeter I own another ten acres of apples, and about a half mile east of that I own thirty-two acres of Navels and also vineyards.

Q. And have you purchased and sold orange groves since 1913?

A. I have purchased orange groves since 1913. My personal purchase—but I haven't sold my own or any since 1913.

Q. Did you have an interest in the 110 acres of oranges and 5 acres of peaches which have been described as the Dofflemeyer ranch?

A. I was one-third partner described as the Dofflemeyer orange orchard. [395]

* * * * *

Q. Did you ever hear of immature oranges on the tree being sold on either August 10th, or September 1st?

A. I never have.

Q. In your experience, what would be the reason that oranges would be sold that early?

A. If a man sold oranges that early it must have been something wrong with his mind, and I would never dream myself of selling oranges at that date, and turn the orchard over to the buyer to take care of them up to the harvest time.

Q. In other words, the buyer would have to go

(Testimony of Louis L. Dofflemyer.)

into the grove and manage the grove until the oranges were harvested?

A. Yes, because he would be after the crop, and he wouldn't care anything about my orchard. It is the culture in the orchard in the fall that produces the next year's crop, if you don't have any real frost.

Q. In other words, a grower would not turn his grove over to a purchaser so that he might grow the crops and then harvest them, is that right?

A. Not if he was in his right mind.

Q. Would you say there is a possibility that the buyer would damage the grove, is that right?

A. The buyer primarily would grow that crop only. In September, for instance, you take and put on manure and put [403] on straw or hay, and in October and November you do the same thing. You may put on your fertilizers and that is no advantage to this year's crop, but it is an advantage to next year's crop.

Q. Now, Mr. Dofflemyer, you have allocated here \$121,000.00 to the orange trees, and you state that included in that figure is \$10,500.00 representing 70,000 boxes of oranges at fifteen cents.

Is it your opinion that on August 10th or September 1st that a willing buyer, that is one who is not compelled to buy, and a willing seller, one who is under no compulsion to sell, that in allocating the values on a grove that they would allocate the fair value of the oranges, the sum of \$10,500.00?

A. If I was allocating for just the crop there would be no allocation, but when I was selling a

(Testimony of Louis L. Dofflemyer.)

grove and the crop and these small oranges were on the trees and there was allocation, that is the way I would allocate it. But as far as going and buying oranges, I wouldn't do it.

Q. Then you would allocate \$10,500.00?

A. Yes, if I sold the trees. [404]

* * * * *

Recross Examination

By Mr. Hurley:

Q. I show you what appears to be a half an orange which was the subject of testimony of your brother, Mr. W. T. Dofflemyer, several days ago, which he stated was a frozen orange.

Is that a navel orange?

A. That is a Valencia.

Q. Is not the type of orange that is on the Dofflemyer property?

A. No, but the inside, the frozen part, the navel and the Valencia have the same on the inside, but the effect would be the same from frost. [421]

* * * * *

JACK M. DUNGAN [478]

called as a witness for and on behalf of the respondent, having been first duly sworn, was examined and testified as follows:

The Clerk: Will you have a seat, please, and state your name and address for the record?

A. Jack M. Dungan, Exeter, California.

Direct Examination

Q. (By Mr. Hurley): Mr. Dungan, how long have you lived in Exeter, California?

(Testimony of Jack M. Dungan.)

A. I was born there in 1903.

Q. And are you appearing in court today in response to a subpoena of this court? A. Yes.

Q. What is your occupation?

A. I am a rancher, orange and grape grower.

Q. How long have you been a grower of oranges?

A. In my own rights, owning property since 1929, and I helped to take care of family property since approximately 1920 on.

Q. Do you own any navel orange property?

A. I do.

Q. How long have you owned that, Mr. Dungan?

A. Oh, twenty years. [479]

* * * * *

Q. That was the condition that I stipulated in my question.

When do navel oranges normally set in Exeter district?

A. Well, I have always considered the new crop started as the bloom appears. That is, everybody has his own idea. That is a question that has never come up.

Q. The crop begins, as I understand it, and as the testimony has been, with the blossoms and then in June, or thereabouts, sometime prior to the first of July, you have what is referred to as a "June drop", is that correct? A. That is correct.

Q. And at that time the crop is said to "set", is that correct? A. That is right.

Q. So that the fruit that is adhering to the trees

(Testimony of Jack M. Dungan.)

at that time is likely to be the matured fruit, naturally, is that correct?

A. Well, there have been exceptions to that. Your June drop, I believe I can say in exceptional years has continued into August, but that is an exception.

Q. Would you say that under the prorated procedures that picking time is not always maturity date?

I mean by that, are oranges always picked as soon as they become matured? A. No. [484]

A. Well, there has been exceptions to that. Your June drop, I believe I can say in exceptional years, has continued into August, but that is an exception.

Q. Would you say that under the prorated procedures that picking time is not always maturity date?

I mean by that, are the oranges always picked as soon as they become mature? A. No.

Q. Why are they allowed to remain on the trees?

A. Well, you just don't pick them, that's that. This fruit matures. You pick it as you come to it. Now as in the case of the prorated, you pick your allotment for that week and the rest is left on the tree. That fruit left on the tree is as mature as the fruit you are picking, generally speaking.

Q. What would you say is the average time that Navels in the Exeter district become mature?

A. The average time, November 15.

Q. About November 15 the Navel crop is mature, most of it?

A. There is enough matured there that you can start picking. [485]

* * * * *

[Endorsed]: No. 12982. United States Court of Appeals for the Ninth Circuit. Ernest A. Watson and M. Gladys Watson, Petitioners, vs. Commissioner of Internal Revenue, Respondent. Transcript of the Record. Petition to Review a Decision of The Tax Court of the United States.

Filed: June 18, 1951.

/s/ PAUL P. O'BRIEN,
Clerk of the United States Court of Appeals for
the Ninth Circuit.

In the United States Court of Appeals
for the Ninth Circuit

Docket No. 12982

ERNEST A. WATSON and M. GLADYS
WATSON,

Petitioners on Review,
vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent on Review.

STIPULATION AND ORDER RE EXHIBITS

It is hereby agreed and stipulated by counsel in the above-entitled case that the original exhibits may be excluded from the printed record but may be referred to by the parties in brief and argument as if part of that record.

/s/ THERON LAMAR CAUDLE,
Assistant Attorney General,
Counsel for Respondent.

/s/ ARTHUR MCGREGOR,
Counsel for Petitioners.

So ordered:

/s/ CLIFTON MATHEWS,
Judge

/s/ WILLIAM HEALY,

/s/ WM. E. ORR,

United States Circuit Judges.

[Endorsed]: Filed July 5, 1951. Paul P. O'Brien,
Clerk.

IN UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT
Excerpt from Proceedings of Monday, February 25, 1952

Before: Denman, Chief Judge; Stephens and Bone, Circuit
Judges

ORDER OF SUBMISSION

Ordered petition to review herein presented by Mr. Arthur McGregor, counsel for petitioners, and by Mr. Iving Axelrod, Special Assistant to the Attorney General, counsel for respondent, and submitted to the court for consideration and decision.

IN UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

Excerpt from Proceedings of Thursday, May 29, 1952

Before: Denman, Chief Judge; Stephens and Bone, Circuit
Judges

ORDER DIRECTING FILING OF OPINION AND FILING AND RECORD-
ING OF JUDGMENT

Ordered that the typewritten opinion this day rendered by this court in above cause be forthwith filed by the clerk, and that a judgment be filed and recorded in the minutes of this court in accordance with the opinion rendered.

IN UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

No. 12,982

ERNEST A. WATSON and M. GLADYS WATSON, Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE, Respondent

Petition to Review a Decision of The Tax Court of the
United StatesBefore: Denman, Chief Judge, and Stephens and Bone,
Circuit Judges

DENMAN, Chief Judge:

OPINION—May 29, 1952

This case is here on a petition to review a decision of the Tax Court, 15 T.C. 800, that the Commissioner of Internal Revenue was correct in assessing a deficiency against the taxpayer, Watson, in respect of personal income taxes for the year 1944. The issue for our determination is to what extent the profit from a sale of an orange grove, consisting of land, trees and an unmaturred crop of oranges, should be apportioned between ordinary income and capital gain. The Commissioner concedes that the profit attributable to the land and trees is capital gain, but contends that the profit attributable to the unmaturred crop of oranges should be allocated to ordinary income. The taxpayer contends that she is entitled to the favorable capital gains treatment for her profit from the unmaturred oranges under 26 U.S.C. § 117(j).

In 1944, the taxpayer owned a one-third interest in an orange grove near Exeter, Tulare County. The property had been operated from January 1, 1942, under a partnership agreement with her two brothers who also owned one-third interests. About May or June of 1944, these owners listed their orange grove for sale with a local real estate agent; and the price eventually sought for this piece of property was \$197,100. The buyer was first contacted in June, but he deferred a decision until the extent of the

orange crop would be better known. On August 10, 1944, the contract for sale was entered into and the growing crop of immature oranges passed to the buyer along with the land. This crop consisted of navel oranges which bloom in the spring. During May and June, a considerable portion of the small fruit drops from the trees; and the oranges which remain on the trees do not mature until early November in the Exeter area. During the negotiations, the manager of the grove estimated the yield for that year would be 70,000 loose boxed. The Tax Court found that this constituted \$40,000. of the \$197,100. paid for the orange grove.

The pertinent portions of § 117(j) (1) are:

"For the purposes of this subsection, the term 'property used in the trade or business' means * * * real property used in the trade or business, held for more than 6 months, which is not * * * property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business."

The taxpayer contends that the unmaturing crop of oranges on the trees is not personal property but is a part of the realty. Assuming this to be correct, the burden of proof is on the taxpayer to show that such oranges were real property which was "held for more than 6 months" and which was not held "primarily for sale to customers in the ordinary course of her trade or business."

It is obvious that even though the oranges are real property vertically held above the ground, they nonetheless may be realty of a different character from the trees which sustain them and the ground which in turn sustains the trees. The analogy is a steel structure consisting of a large department store which a seller of real estate holds not for sale but for its rental as a permanent capital investment, but which also sustains ten stories of apartments, which are real property, and which the dealer holds primarily for sale of the fee interest in the individual apartments "to customers in the ordinary course of his trade or business" as a real estate dealer. A further analogy is that of a real estate dealer, owner of a thousand acres of land which he rents for pasture as a capital investment, but in which he later sets apart a hundred acres for sub-

division into lots which he holds for sale to customers in the ordinary course of his business. Cf. *Rollingwood v. C.I.R.*, 190 F. 2d 263 (Cir. 9).

It is equally obvious that the only purpose of the taxpayer for the years prior to May, 1944, in holding the portion of property which consisted of the crop was to sell the crop to her customers annually in a business of orange selling. We hence agree with the Tax Court's conclusion and holding that the oranges sold by petitioner and her brothers did not constitute real estate used by them in their trade or business which was "not . . . (B) property held by [them] primarily for sale to customers in the ordinary course of [their] trade or business," and accordingly, the provisions of section 117(j) do not apply.

The situation is equally clear if the orange crop on the trees be regarded as personalty. The only purpose for which it is held is for sale to customers in the business of orange selling.

Since the purpose of capital gains relief is to avoid ordinary income taxation on the realization of values that have accumulated over a long period of time, we are re-enforced in our conclusion that the growing crop here is not entitled to the relief of § 117(j). The value of the crop is largely the product of effort within the tax year and the periodic realization of income from the crop covers a short period approximating the tax year. *Rollingwood Corp. v. C.I.R.*, *supra*.

It is contended that in May, 1944, the taxpayer ceased to hold the oranges for such sale to customers when she decided with the co-owners of the orchard to hold it with its crop for a unit sale—a holding of the orchard and crop for a sale not in the ordinary course of any business of the taxpayer. Assuming this decision to sell the property as a unit changed the character of the holding of the crop, § 117(j) (1) is not satisfied, for the crop was not held in the non-business sale character for the six months required by that section.

The Tenth Circuit in *McCoy v. Commissioner*, 192 F. 2d 486 at 488, dealt with land sold with its immature crop of grain as a whole. It held that the profit of the sale of both crop and land constituted a capital gain. That court does not consider the contention that the annual grain crop

though realty is a different kind of realty from the land on which it is grown. It cites but a portion of § 117(j) (1) "real property used in the trade or business held for more than six months" omitting the words, "which is not held * * * by the taxpayer primarily for sale to customers in the ordinary course of his trade or business." There, as here with the orange crop, it is clear that the annual grain crop is "held" while growing for no other purpose than for sale to customers in the ordinary course of business.

Now do we agree with the Tenth Circuit that its opinion is re-enforced by § 323 of the Revenue Act of 1951 which amends § 117(j) to allow capital gains treatment for unmatured crops sold along with the land and trees to the same buyer. The legislation states that it applies to tax years after December 31, 1950, and the Senate Report accompanying the bill states that when the amendment is effective there will be an annual loss in taxes collected of \$3,000,000. Here is a clear recognition that § 117(j) (1) prior to amendment is as interpreted by the Tax Court and this opinion.

In the Fifth Circuit, *Owen v. Commissioner*, 192 F. 2d 1006, dealt with a Florida orange grove and treated the orange crop as appurtenant to the realty *when sold*. It reasoned that although the crop may have been held for sale in the course of trade or business up to a week before the day of the sale of the land with the crop on the trees, it is the character of the owner's holding on the day of sale which is determinative. Its language at page 1008 is:

"The fact that the fruit was potentially property held for sale in the ordinary course of business, and for that purpose could have been severed and separately sold by the taxpayer, does not justify imposing a tax upon it in that status, when in fact no such transaction occurred. Taxation must follow the facts."

And at page 1009:

"* * * it was not, *at the time of these sales*, (our emphasis) property held *primarily* for sale in the *ordinary* course of her business. We repeat, there was no

sale of the fruit as personalty severed from the freehold."

Obviously, the last-quoted language ignores the requirement of § 117(j) (1) that the taxpayer must show that the crop was not held for a business sale but for a sale as a unit with the land "for more than six months."

The decision of the Tax Court is affirmed.

[Endorsed]: Opinion. Filed May 29, 1952. Paul P. O'Brien, Clerk.

IN UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

No. 12982

ERNEST A. WATSON and M. GLADYS WATSON, Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE, Respondent

JUDGMENT—Filed and entered May 29, 1952.

Upon Petition to Review a Decision of The Tax Court of the United States.

This Cause came on to be heard on the Transcript of the Record from The Tax Court of the United States, and was duly submitted.

On Consideration Whereof, it is now here ordered and adjudged by this Court, that the Decision of the said Tax Court of the United States in this Cause be, and hereby is affirmed.

Clerk's Certificate to the foregoing transcript omitted in printing.

SUPREME COURT OF THE UNITED STATES, OCTOBER TERM, 1952

No. 290

ERNEST A. WATSON and M. GLADYS WATSON, Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE

ORDER ALLOWING CERTIORARI—Filed December 8, 1952

The petition herein for a writ of certiorari to the United States Court of Appeals for the Ninth Circuit is granted. The case is transferred to the summary docket.

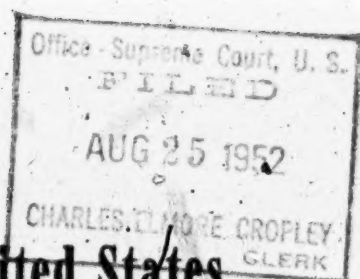
And it is further ordered that the duly certified copy of the transcript of the proceedings below which accompanied the petition shall be treated as though filed in response to such writ.

(5591)

IN THE
Supreme Court of the United States

October Term, 1952

No. **290**



LIBRARY
SUPREME COURT, U. S.

ERNEST A. WATSON and M. GLADYS WATSON,

Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

Petition for Writ of Certiorari to the United States
Court of Appeals for the Ninth Circuit and Brief
in Support Thereof.

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HOWARD W. REYNOLDS,
ADAM Y. BENNION,
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Of Counsel.

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I.

Under the law of the State of California and the Law of the vast majority of the states, an unmaturing, unsevered, growing crop is part of the real property to which it is attached	13
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II.

The unmaturing oranges were not held by petitioners primarily for sale to customers in the ordinary course of trade or business. The holding period of the crop did not commence at the time the property was listed for sale, but began either on the acquisition date of the land itself or in any event immediately after the old crop was removed, both of which periods are in excess of six months. 14	14
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III.

The holdings of the Courts of Appeals for the Fifth Circuit and for the Tenth Circuit respecting sales of agricultural land with growing crops thereon are in direct conflict with the holding of the Ninth Circuit in the instant case. Uncertainties exist with respect to the application of the federal revenue laws which should be resolved by the decision of the Supreme Court of the United States..... 1

Conclusion 1

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IN THE
Supreme Court of the United States

October Term, 1952

No.

ERNEST A. WATSON and M. GLADYS WATSON,

Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

Petition for Writ of Certiorari to the United States
Court of Appeals for the Ninth Circuit.

*To the Honorable the Supreme Court of the United
States:*

Your petitioners respectfully show:

Statement of the Matter Involved.

The issue presented to this Court is whether a portion of the sale price of an orange grove should be allocated to the unripe oranges on the trees and treated as ordinary income, where there has been a sale of land and trees with an unripe crop of oranges thereon for a lump sum consideration; or whether the sale in its entirety should be treated as coming within the purview of Section 117(j) of the Internal Revenue Code (Title 26,

U. S. C. A., Sec. 117) and the gain therefrom taxed as capital gain.

The petitioners are husband and wife who filed a joint individual income tax return for the year 1944 with the Collector of Internal Revenue at Los Angeles, California. [R. 57.] The wife, M. Gladys Watson, and her two brothers each owned an undivided one-third interest in a 115-acre tract of land, of which 110 acres were a navel orange grove and five acres were a peach orchard. [R. 57.] This property was known as the Dofflemyer Grove and is situated near Exeter, Tulare County, California. [R. 57, 75.] The co-owners had acquired the property on December 31, 1941, upon dissolution of a family corporation. [R. 20.] However, the family had supervised or managed the ranch since the year 1912 or 1913. [R. 21, 74.] On August 10, 1944, the co-owners entered into an escrow agreement for the sale of this property, together with the improvements, water rights and equipment thereon, for a lump sum consideration of \$197,100.00. [R. 57, 78.] Petitioner, M. Gladys Watson, reported the sale of her one-third interest on the joint 1944 income tax return of husband and wife as a sale of assets falling within the purview of Section 117(j) of the Internal Revenue Code, and treated the gain thereon as capital gain. [R. 30.]

Pursuant to the escrow agreement of August 10, 1944, \$10,000.00 in cash was paid by the purchaser on that date and the balance of the purchase price was paid and the deed to the property was delivered on September 1, 1944. [R. 78, Ex. 5.] The original agreement required the seller to furnish a policy of title insurance in the amount of \$197,100.00. Documentary stamps were attached to the deed in the amount of \$217.25, representing

the tax under Section 3482 of the Internal Revenue Code, based upon the entire consideration paid for the property. (55 cents for each \$500.00 or fractional part of the consideration or value of real property conveyed.) [R. 78, Ex. 5.]

At the time of the sale the orange trees had upon them green, immature fruit which would not begin to mature for a period of at least three months thereafter. [R. 58, 81, 113.] Picking would then start and continue under the prorate system through January of the following year. [R. 83, 84.] The sales agreement made no mention of a crop of oranges on the trees and treated the sale in its entirety as a sale of real property, making no allocation of the sale price. [R. 78, Ex. 5.] /

Petitioner, M. Gladys Watson, and her brothers operated the Dofflemyer Grove under a partnership agreement. [R. 74, 75.] Their occupation was farming and fruit growing. [R. 74, 121.] They were not in the business of selling orange groves. [R. 74, 75.] Neither was it their business to sell immature fruit on the trees. They had never made such a sale prior to the sale here in question, and it was entirely out of their contemplation to have sold their immature fruit on the trees either on August 10 or September 1 of the year 1944 or any other year. [R. 94, 95, 122, 123.]

During the year 1944 and in prior years in California under the prorate system, there was no buying of fruit on the trees. [R. 95.] At the date of the sale the fruit on the trees would have had no value if picked. [R. 94.] It was small, green and pulpy, and lacked the required amount of soluble solids and acids. [R. 81, 82.] The petitioner, M. Gladys Watson, and her brothers in operating their grove followed the procedure of selling picked,

ripe oranges through the California Fruit Growers Exchange. This is a marketing organization which sells the pooled fruit of many growers in the eastern markets, and remits to each grower his proportionate part of the average selling price received for the pool. [R. 87, 88.]

The United States Tax Court allocated \$40,000.00 of the purchase price to the immature fruit and held that this amount represented ordinary income and was not to be treated as gain from the sale of capital assets within the purview of Section 117(j) of the Internal Revenue Code. [R. 31.] The Court of Appeals for the Ninth Circuit affirmed upon the ground that the immature fruit represented property held by the petitioner primarily for sale to customers in the ordinary course of her trade or business and, therefore, that the sale was not within the scope of said Section 117(j). The Appellate Court further stated that assuming that the decision to sell the grove as a unit made the holding of the immature crop a holding for sale not in the ordinary course of business, in this event the crop had not been so held for a period in excess of six months, inasmuch as the decision to sell was made in April or May and the sale occurred in September. The issues presented by this petition involve the correctness of these holdings by the Court of Appeals for the Ninth Circuit.

Jurisdictional Statement.

The Supreme Court has jurisdiction to review the judgment here in question on the following grounds. The original proceeding was brought in the Tax Court of the United States and a decision was rendered by such court. Petitioners in due time filed a petition for review of said decision with the Court of Appeals for the Ninth Circuit,

which in turn rendered its decision. The statutory authority conferring jurisdiction is Section 1141(a) of the Internal Revenue Code. (Title 26, U. S. C. A., Sec. 1141.) This section provides that the Courts of Appeals shall have exclusive jurisdiction to review the decisions of the United States Tax Court; and the judgment of such Courts of Appeals shall be subject to review by the Supreme Court of the United States upon certiorari, in the manner provided in Section 1254 of Title 28 of the United States Code. The issues presented by this appeal are primarily questions of law involving a construction of the meaning of Section 117 of the Internal Revenue Code and are proper matters for review.

The Question Presented.

The principal issue is, when a farmer sells an orange grove which he has held and operated many years, with unmaturing fruit on the trees, for a lump sum consideration, whether the unmaturing fruit on the trees is a part of the real property used in the taxpayers' trade or business held for more than six months and comes within the purview of Section 117(j) of the Internal Revenue Code, or whether the unmaturing fruit represents property held primarily for sale to customers in the ordinary course of the taxpayers' trade or business.

A second issue is whether the holding period for such property was a period in excess of six months. As an alternative ground for its decision the Court of Appeals for the Ninth Circuit stated that the holding period of the green fruit began on the date it became the intention of the parties to sell the grove as a unit, and that therefore the property had been held only from May to September, less than six months. [R. 135, 136.]

Reasons Relied Upon for Allowance of Writ.

The decision of the Court of Appeals is in conflict with decisions of the Courts of Appeals for two other circuits on the same matter. (Supreme Court Rule 38, par. 5(b).) The matter presented in both of those cases is the proper treatment for income tax purposes, of the sale proceeds of agricultural property sold as a unit for a lump sum, where at the time of sale such agricultural property had upon it an immature, unsevered crop.

The case of *McCoy v. Commissioner of Internal Revenue*, 192 F. 2d 486, involved a farmer who owned farming land for more than six months and had used the same in his business as a farmer. He sold the farming land at a time when it had an immature growing wheat crop upon it. The Court of Appeals for the Tenth Circuit held that the crop was a part of the realty and the gain realized thereon was to be treated as capital gain within the purview of Section 117(j)(1) of the Internal Revenue Code.

The second case, *Owen v. Commissioner of Internal Revenue*, 192 F. 2d 1006, involved a fruit grower engaged in the business of growing and selling citrus fruits in Florida. She sold an orange grove held by her for a period in excess of six months, together with equipment and immature, unsevered fruit on the trees, for a lump sum consideration. The Court of Appeals for the Fifth Circuit held that the immature fruit was to be treated as a capital asset and that the profit on the sale was to be taxed along with the land as a long term capital gain.

The Court of Appeals for the Ninth Circuit in the instant case, while assuming the immature fruit to be real property, held nevertheless that the same was real property of a character different from the land and trees, *i. e.*, property held primarily for sale to customers in the ordinary course of trade or business, and that the gain thereon was to be treated not as capital gain but as ordinary income.

The two decisions in the Fifth and Tenth Circuits are not distinguishable from the case at bar. A conflict of decisions exists which should be resolved by this Honorable Court.

Petitioner submits that the issue decided by the Court of Appeals for the Ninth Circuit is an important question of federal tax law. For taxable years subsequent to December 31, 1950, Section 117(j) as amended by Section 323 of the Revenue Act of 1951 specifically provides that upon the sale of land with an unharvested crop the gain from such sale shall be treated as capital gain. However, respecting sales of agricultural land with immature crops made in taxable years ending on or prior to December 31, 1950, the tax liability of sellers is uncertain. Such uncertainty will only be dispelled by a decision of this Court.

Wherefore, your petitioners pray that a writ of certiorari issue under the seal of this Court, directed to the Court of Appeals for the Ninth Circuit, commanding said Court to certify and send to this Court a full and complete transcript of the record and of the proceedings.

of said Court of Appeals had in the case numbered and entitled on its docket No. 12982, Ernest A. Watson and M. Gladys Watson, Petitioners, vs. Commissioner of Internal Revenue, Respondent, to the end that this cause may be reviewed and determined by this Court as provided for by the statutes of the United States; and that the judgment herein of said Court of Appeals be reversed by this Honorable Court, and for such further relief as it may deem proper.

Dated: August 22, 1952.

Respectfully submitted,

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HOWARD W. REYNOLDS,
ADAM Y. BENNION,
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Of Counsel.

IN THE
Supreme Court of the United States

October Term, 1952

No.

ERNEST A. WATSON and M. GLADYS WATSON,
Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

**BRIEF IN SUPPORT OF PETITION FOR WRIT
OF CERTIORARI.**

The Opinion Below.

The opinion of the United States Court of Appeals for the Ninth Circuit is reported in 197 Federal Reporter 2d 56. (Advance Sheets, August 4, 1952.). The opinion is also printed in full in the record. [R. 132-137.]

Jurisdiction.

The jurisdiction of this Court is invoked under Section 1141(a) of the Internal Revenue Code. (Title 26 U. S. C. A., Sec. 1141.) The Court of Appeals for the Ninth Circuit in this case reviewed and affirmed the decision of the Tax Court of the United States. The affirming decision is subject to review by the Supreme Court of the United States upon certiorari. The decision of the Court of Appeals for the Ninth Circuit conflicts with decisions of the Courts of Appeals for the Fifth

Circuit and for the Tenth Circuit on the same matter. (Supreme Court Rule 38(5)(b).)

Judgment was entered in this case by the United States Court of Appeals on May 29, 1952. [R. 138.]

Statement of the Case.

The facts in this case follow a simple pattern. Three individuals owned a navel orange grove which had been held and operated by them or members of their family since 1913. They acquired legal title to the grove on December 31, 1941, upon dissolution of a family corporation. [R. 20, 21, 74.] In May, 1944, they listed the grove for sale with a local real estate broker. [R. 89.] In due course the real estate broker found a purchaser at the original asking price of \$197,100.00. [R. 89, 90.] The trees put forth their blossoms in the spring. By approximately July first a crop of green oranges had set on the trees. Beginning in November and continuing into December and January the crop of oranges matured and was picked. [R. 80-82.] The co-owners entered a binding escrow agreement on August 10, 1944, wherein the sale was considered in its entirety as a sale of real estate with farming equipment. On September 1, 1944, the escrow closed and the sellers received a deed to the real property. At the date of the sale the trees had on them the immature growing crop of oranges. Nowhere in the entire transaction is any mention made of the immature crop. [R. 78-80; Ex. 5.] Under the established California law the immature crop passed to the purchaser as part of the real estate. If severed from the trees at the date of sale the green crop would have been worthless. Its sale as picked fruit was prohibited by both federal and state laws. Petitioner, M. Gladys Watson, and her

brothers were in the business of selling picked, ripe fruit (personalty) to eastern buyers through the California Fruit Growers Exchange. [R. 85-88.] They were not in the business of selling unma^{ture} fruit on the trees, nor did they ever hold such unma^{ture} fruit on the trees for sale. [R. 122, 123.]

Petitioner, M. Gladys Watson, for federal income tax purposes, reported her entire gain from the sale of the grove as capital gain under Section 117(j) of the Internal Revenue Code. The Commissioner determined that an allocation of a portion of the sale price should be made to the unma^{ture} fruit and thereupon allocated the sum of \$122,500.00 out of the \$197,100.00 as the value of the unma^{ture} fruit and taxed the petitioner on her portion thereof as ordinary income. [R. 12-13.] The Tax Court upheld the Commissioner in taxing the portion of the proceeds allocated to the unma^{ture} fruit as ordinary income, but allocated \$40,000.00 of the sale price to the value of the unma^{ture} fruit in lieu of \$122,500.00. [R. 19-56.] The Court of Appeals for the Ninth Circuit affirmed.

Specification of Errors.

1. The United States Court of Appeals erred in holding that the unma^{ture} fruit was property held primarily for sale to customers in the ordinary course of trade or business, and in failing to hold that the same was real property coming within the purview of Section 117(j) of the Internal Revenue Code.

2. The Court further erred in deciding in the alternative that the holding period of the unma^{ture} fruit commenced when the parties decided to sell the property as a unit, rather than when the property was acquired.

Summary of Argument.

- I. Under the law of the State of California and the law of the vast majority of the states, an unmature, unsevered, growing crop is part of the real property to which it is attached.
- II. The unmature oranges were not held by petitioners primarily for sale to customers in the ordinary course of trade or business. The holding period of the crop did not commence at the time the property was listed for sale, but began either on the acquisition date of the land itself or in any event immediately after the old crop was removed, both of which periods are in excess of six months.
- III. The holdings of the Courts of Appeals for the Fifth Circuit and for the Tenth Circuit respecting sales of agricultural land with growing crops thereon are in direct conflict with the holding in the Ninth Circuit in the instant case. Uncertainties exist with respect to the application of the federal revenue laws which should be resolved by the decision of the Supreme Court of the United States.

ARGUMENT.

I.

Under the Law of the State of California and the Law of the Vast Majority of the States, an Unmature, Unsevered, Growing Crop Is Part of the Real Property to Which It Is Attached.

The California courts from the earliest times have held that an unmature, unsevered, growing crop of fruit on the trees is a part of the real estate. The decisions of the Supreme Court of California have consistently recognized the peculiar nature of growing crops and have held that they have no independent existence apart from the land to which they are attached and upon which they depend for nutriment. The following California cases support this rule. *Penryn Fruit Co. v. Sherman-Worrell Fruit Co., et al.*, 142 Cal. 643, 76 Pac. 484; *Huerstal v. Muir*, 64 Cal. 450, 2 Pac. 33; *Dascey v. Harris*, 65 Cal. 357, 4 Pac. 204; *Wilson v. White*, 161 Cal. 453, 119 Pac. 895; *Fiske v. Soule*, 87 Cal. 313, 25 Pac. 430; *Young v. Bank of California* (1948), 88 Cal. App. 2d 184, 198 P. 2d 543. The Court of Appeals for the Ninth Circuit assumes in its opinion in the instant case that the unmature fruit was a part of the real property. (197 F. 2d 56, at p. 57.) Nonetheless, the Court holds that such unmature fruit was realty of a different character from the trees and ground which sustained it. Such holding is erroneous as growing crops have no independent existence apart from the land. The California Supreme Court in *Cottle v. Spitzer*, 65 Cal. 456, 4 Pac. 435, states that growing crops are not sufficiently tangible to be treated as property.

II.

The Unmature Oranges Were Not Held by Petitioners Primarily For Sale to Customers in the Ordinary Course of Trade or Business. The Holding Period of the Crop Did Not Commence at the Time the Property Was Listed For Sale, but Began Either on the Acquisition Date of the Land Itself or in Any Event Immediately After the Old Crop Was Removed, Both of Which Periods Are in Excess of Six Months.

Petitioner, M. Gladys Watson, and her brothers sold an orange grove which had been in their family since 1913. They were not attempting to dispose of the unmature crop as such. The sale terminated an enterprise which they had carried on for thirty years. [R. 74.] When the grove was listed for sale in May, 1944, the crop of oranges had not survived the annual June drop. The blossoms and fruit had no measurable value. The original price at which the grove was offered was never changed. [R. 78, 80; 89.] It was evident that the sellers were not attaching any particular value to the crop and were not holding the crop primarily for sale in the ordinary course of their trade or business.

Analogous decisions have held that natural products attached to the land and not in final salable form do not constitute "property held primarily for sale to customers in the ordinary course of trade or business." In *Butler Consolidated Coal Company*, 6 T. C. 183, the Tax Court so held with regard to sale of property containing "coal in place" by one engaged in the business of mining and

selling coal. In *Carroll v. Commissioner*, 70 F. 2d 806, the Court of Appeals for the Fifth Circuit so held with regard to sale of standing timber by one engaged in the business of cutting such timber, sawing it into lumber and selling the lumber.

Petitioner, M. Gladys Watson, and her brothers never previously made a sale of immature fruit on the trees. In California there were no purchasers of green fruit on the trees in August or September of 1944 or any other year. [R. 122, 123.] At this time the fruit was held only for possible ultimate sale if it finally matured, was picked, packed and shipped to market. It was not held primarily for sale to customers in the ordinary course of trade or business. Consequently, the listing of the grove with real estate broker would not in any way change the length of the holding period. Until the oranges were mature and severed from the trees and it was actually known that there would be a marketable crop, there was no definite intention to hold the crop for sale as such. The growing crop had no independent existence apart from the land and the holding therefore began at the time the land was acquired in liquidation of the family corporation on December 31, 1941. The holding period of the crop in any event was more than six months. The uncontradicted testimony of the respondent's witness shows that the crop began in December, 1943, or January, 1944, immediately after the old crop was picked, and the sale was made eight or nine months later. [R. 111.]

III.

The Holdings of the Courts of Appeals for the Fifth Circuit and for the Tenth Circuit Respecting Sales of Agricultural Land With Growing Crops Thereon Are in Direct Conflict With the Holding of the Ninth Circuit in the Instant Case. Uncertainties Exist With Respect to the Application of the Federal Revenue Laws Which Should be Resolved by the Decision of the Supreme Court of the United States.

A conflict of decisions exists with respect to the federal income tax liability of sellers who sell agricultural land having upon it an immature growing crop. A brief review of the three decisions in *McCoy v. Commissioner*, 192 F. 2d 486, *Owen v. Commissioner*, 192 F. 2d 1006, and the case at bar, shows the existence of such conflict. There is no basis for distinguishing the cases upon their facts. In each case the Court holds or assumes that under the applicable local law of Kansas, Florida and California, respectively, that a growing, unsevered crop is real property. In each case the property was sold as a unit and transferred by a deed to the land which conveyed, without separate mention, the trees and growing crops. In each case, with a slight exception in the *Owen* case, the crop was immature and would have been worthless on the date of sale if severed from the soil which gave it nutriment. The Fifth and Tenth Circuits decided that the growing crop was real property used in the taxpayer's trade or business and held for a period of more than six months within the meaning of Section

117(j) of the Internal Revenue Code. The Ninth Circuit held to the contrary.

In its opinion (197 F. 2d 56, at p. 58) the Court of Appeals for the Ninth Circuit states that the Tenth Circuit in the *McCoy* case ignored the requirement of Section 117(j) of the Code which excludes property "held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business."

At page 59 of the opinion the Court quotes from the case of *Owen v. Commissioner*, and states that this case ignores the requirement of Section 117(j)(1) that the taxpayer must show that the crop was not held for a business sale but for a sale as a unit with the land for more than six months.

The Ninth Circuit in its opinion recognizes that its decision cannot be reconciled to those of the Fifth and Tenth Circuits. Certiorari should be granted so that the conflict of decisions among the Circuits may be resolved.

Petitioners also urge that a writ of certiorari be granted upon the ground that the decision involves an important point of the federal revenue law which is unsettled. Respecting sales of agricultural lands with growing crops, in taxable years ending on or before December 31, 1950, the Commissioner of Internal Revenue is contending that an allocation of the sale price is required, treating the allocation to the growing crop as ordinary income. It should be noted that no attempt was made by the Commissioner of Internal Revenue to tax

unmature crops as ordinary income prior to the Commissioner's ruling *L. T. 3815*, 1946-2 C. B. 30, promulgated in 1946. At the time of the sale in the instant case there was no ruling or attempt on the part of the Commissioner to allocate part of the sale price to unmature crops. For the Commissioner to change such administrative policy at this late date is arbitrary and discriminatory. However, for his position he has support in the decision of the Ninth Circuit in the instant case. On the other hand taxpayers prior to 1946 have reported such sales as sales of capital assets falling within the purview of Section 117(j) of the Internal Revenue Code in their entirety. In so doing taxpayers have been sustained by the Courts of Appeals for the Fifth and the Tenth Circuits:

Conclusion:

The petitioner, M. Gladys Watson, and her brothers were engaged in the occupation of farming. They were not in the business of selling real estate. Growing crops unsevered from the land are part of the real estate to which they are attached and have no independent existence. The law of the State of California and the common law so hold, as do practically all of the other states of the United States. The disposition of an entire grove with unmature fruit upon the trees does not represent a sale of oranges held primarily for sale to customers in the ordinary course of trade or business. The entire transaction falls within the purview of Section 117(j) of the Internal Revenue Code as has been decided by

the Courts of Appeals for the Fifth and Tenth Circuits. To hold otherwise is arbitrary and discriminatory. A writ of certiorari should be granted to resolve the conflict between the decisions of those Courts and the decision of the Court of Appeals for the Ninth Circuit. The decision of the Court of Appeals for the Ninth Circuit should be reversed.

Dated: August 22, 1952.

Respectfully submitted,

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APPENDIX.

Internal Revenue Code (Title 26, U. S. C. A., Sec. 117.)

Sec. 117(j)(1). Definition of property used in the trade or business.—For the purposes of this subsection, the term “property used in the trade or business” means property used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 23(1), held for more than 6 months, and real property used in the trade or business, held for more than 6 months, which is not (A) property of a kind which would properly be includible in the inventory of the taxpayer if on hand at the close of the taxable year, or (B) property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business. Such term also includes timber with respect to which subsection (k) (1) or (2) is applicable.

(2.) General rule.—If, during the taxable year, the recognized gains upon sales or exchanges of property used in the trade or business, plus the recognized gains from the compulsory or involuntary conversion (as a result of destruction in whole or in part, theft or seizure, or an exercise of the power of requisition or condemnation or the threat or imminence thereof) of property used in the trade or business and capital assets held for more than 6 months into other property or money, exceed the recognized losses from such sales, exchanges, and conversions, such gains and losses shall be considered as gains and losses from sales or exchanges of capital assets held for more than 6 months. If such

gains do not exceed such losses, such gains and losses shall not be considered as gains and losses from sales or exchanges of capital assets. For the purposes of this paragraph:

(A) In determining under this paragraph whether gains exceed losses, the gains and losses described therein shall be included only if and to the extent taken into account in computing net income, except that subsections (b) and (d) shall not apply.

(B) Losses upon the destruction, in whole or in part, theft or seizure, or requisition or condemnation of property used in the trade or business or capital assets held for more than 6 months shall be considered losses from a compulsory or involuntary conversion.

Service of the within and receipt of a copy thereof is hereby admitted this.....day of August, A. D. 1952.

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IN THE

Supreme Court of the United States

October Term, 1952

No. 290

ERNEST A. WATSON and M. GLADYS WATSON,

Petitioners,

vs.
COMMISSIONER OF INTERNAL REVENUE,

Respondent.

On Writ of Certiorari to the United States Court of Appeals
for the Ninth Circuit.

BRIEF FOR THE PETITIONER.

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IN THE
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vs.

COMMISSIONER OF INTERNAL REVENUE,

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On Writ of Certiorari to the United States Court of Appeals
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BRIEF FOR THE PETITIONER.

Opinions Below.

The opinion of the Tax Court [R. 19-50] and the dissenting opinion [R. 50-55] are reported at 15 T. C. 800. The opinion of the Court of Appeals [R. 132-137] is reported at 197 F. 2d 56.

Jurisdiction.

The judgment of the Court of Appeals [R. 138] was entered on May 29, 1952. The petition for a writ of certiorari was filed on August 25, 1952, and was granted on December 8, 1952. The jurisdiction of this Court is invoked under 28 United States Code, Section 1254. (See also 26 U. S. C., Sec. 1141.)

Questions Presented.

The principal issue is: Whether immature, unsevered fruit upon the trees of an orange grove, which had been held and operated for a number of years by a farmer taxpayer, and was sold for a lump sum, unallocated consideration, was part of the real property used in the taxpayer's trade or business within the purview of Section 117(j) of the Internal Revenue Code, or was it property held primarily for sale to customers in the ordinary course of the taxpayer's trade or business.

A second issue is: Whether the holding period for such property was a period in excess of six months. As an alternative ground for its decision the Court of Appeals for the Ninth Circuit stated that the holding period of the immature fruit began on the date it became the intention of the parties to sell the grove as a unit, and that therefore the property had been held only from May to September, less than six months. [R. 135, 136.]

Statute Involved.

The applicable provisions of Section 117 of the Internal Revenue Code, 26 United States Code, Section 117, provided as of the year 1944, the year involved in this case:

"INTERNAL REVENUE CODE:

SEC. 117. CAPITAL GAINS AND LOSSES.

(a) [as amended by Section 115(b), Revenue Act of 1941, c. 412, 55 Stat. 687, and Section

151(a), Revenue Act of 1942, c. 619, 56 Stat. 798]

Definitions.—As used in this chapter—

(1) *Capital Assets.*—The term 'capital assets' means property held by the taxpayer (whether or not connected with his trade or business), but does not include stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business, or property used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 23(1), or an obligation of the United States or any of its possessions, or of a State or Territory, or any political subdivision thereof, or of the District of Columbia, issued on or after March 22, 1941, on a discount basis and payable without interest at a fixed maturity date not exceeding one year from the date of issue, or real property used in the trade or business of the taxpayer;

* * * * *

(j) [as added by Section 451(b), Revenue Act of 1942, *supra*, and amended by Section 127(b), Revenue Act of 1943, c. 63, 58 Stat. 21] *Gains and Losses From Involuntary Conversion and From the Sale or Exchange of Certain Property Used in the Trade or Business.*—

(1) *Definition of Property Used in the Trade or Business.*—For the purposes of this subsection, the term 'property used in the trade or business' means property used in the trade or business, of a character which is subject to the allowance for

depreciation provided in section 23(1); held for more than 6 months, and real property used in the trade or business, held for more than 6 months, which is not (A) property of a kind which would properly be includible in the inventory of the taxpayer if on hand at the close of the taxable year, or (B) property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business. Such term also includes timber with respect to which subsection (k)(1) or (2) is applicable.

(2) *General Rule.*—If, during the taxable year, the recognized gains upon sales or exchanges of property used in the trade or business, plus the recognized gains from the compulsory or involuntary conversion (as a result of destruction in whole or in part, theft or seizure, or an exercise of the power of requisition or condemnation or the threat or imminence thereof) of property used in the trade or business and capital assets held for more than 6 months into other property or money, exceed the recognized losses from such sales, exchanges, and conversions, such gains and losses shall be considered as gains and losses from the sales or exchanges of capital assets held for more than 6 months. If such gains do not exceed such losses, such gains and losses shall not be considered as gains and losses from sales or exchanges of capital assets. For the purposes of this paragraph:

(A) In determining under this paragraph whether gains exceed losses, the gains and losses described therein shall be included only if and to the extent taken into account in computing net income, except that subsections (b) and (d) shall not apply.

(B) Losses upon the destruction, in whole or in part, theft or seizure, or requisition or condemnation of property used in the trade or business or capital assets held for more than 6 months shall be considered losses from a compulsory or involuntary conversion."

Statement.

The taxpayer,* M. Gladys Watson, one of the petitioners herein, and her two brothers, W. Todd Dofflemyer and Lewis L. Dofflemyer, each owned an undivided one-third interest in a 115-acre tract of land (known as the Dofflemyer Grove), consisting of a 110-acre navel orange grove and a 5-acre peach orchard, situated near Eweter, Tulare County, California. [R. 57, 75.] The taxpayer and her co-owners had acquired the property on December 31, 1941, upon dissolution of a family corporation. Taxpayer's brothers had supervised and managed the grove since the year 1912 or 1913. From and after January 1, 1942, the three co-owners had operated the property under a partnership agreement. [R. 20, 21, 74.]

In May, 1944, taxpayer and her brothers listed the Dofflemyer Grove and an 80-acre vineyard with a packing house on it with H. C. Balaam, a local real estate agent. The sale price set was a lump sum for both properties of \$329,100.00. The real estate broker secured an offer of \$132,000.00 for the vineyard property. Thereupon taxpayer and her brothers withdrew the vineyard from sale and agreed that the asking price for the grove, 5-acre peach orchard, and equipment should be \$197,100.00, or the difference between the asking price for all

*The taxpayers are husband and wife, who filed a joint return. Since the interest in the property sold was owned by the wife, she shall be referred to as the taxpayer.

the properties and the amount of the offer for the vineyard property. [R. 21, 89, 90.] Balaam secured a purchaser for the property, one J. W. C. Pogue, of Exeter, California. On August 10, 1944, an escrow agreement was entered into with Pogue, which provided for sale of the Dofflemyer Grove, the peach orchard and equipment to him at the original asking price of \$197,100.00. Pursuant to this agreement \$10,000.00 was paid on August 10, 1944, and the balance of the purchase price was paid in cash and the deed to the property given on September 1, 1944. The escrow agreement treated the sale in its entirety as a sale of real property and made no allocation of the sale price to equipment, immature fruit, trees or land. The original agreement required the seller to furnish a policy of title insurance in the amount of \$197,100.00. Documentary stamps which are required in the sale of real property were attached to the deed in the amount of \$217.25, representing a value based upon the entire consideration paid for the property, that is, 55 cents for each \$500.00 or fraction thereof. [R. 22, 78; Ex. 5.]

—At the time of the contract of sale the orange trees had upon them immature fruit which would not begin to mature and be picked for a period of at least three months. [R. 30, 81-84, 113.] The agreement made no mention of the immature crop of oranges. Unknown to the sellers, the buyer, Pogue (for income tax purposes), made an allocation of his purchase price, wherein he allocated \$120,000.00 to the immature crop and the balance of \$77,100.00 to the land, trees, irrigation system, improvements and equipment upon the property. [R. 30.]

At the time of the sale there were 11,566 trees on the 110-acre grove of navel oranges and 406 trees on the

5 acres of peach orchard. The orange grove was planted about 1896. It was one of the best groves in the Exeter area. The soil was well suited for citrus trees and the grove had sufficient water available for irrigation. The taxpayer and her brothers followed excellent farming methods and practices and the annual per acre production from the grove was about twice the average per acre production for Tulare County. [R. 24.] The cost of cultivating the grove from January 1, 1944, to the date of sale was \$16,020.54 and was taken as a deduction by the operating partnership in its return of income for 1944. [R. 29.]

Navel oranges bloom in the spring and from the blooms small fruit forms on the trees. During May and June, and even later, but, principally during June, a considerable portion of the small fruit drops from the trees. After this has occurred, usually around the first part of July in the Exeter area, the orange crop is said to become "set," that is, ordinarily it will thereafter continue to adhere to the tree. The fruit begins to mature in the latter part of November and the major portion of it is picked in December and January, only 6 per cent of the fruit is picked in November and none prior to that time. [R. 26, 81-84, 113.] During the year 1944 there was in effect in the Exeter area the "prorate" system of picking and marketing oranges, which allowed a grower to pick and ship only a certain percentage of his fruit during each week of an eight or ten week marketing period. [R. 27, 83-84.]

There are a number of scales and pests to which growing navel oranges are subject and these pests, in the year 1943, caused a loss of 2 per cent of the crop on the Dofflemeyer Grove. [R. 26.] However, the most damaging element to an orange crop in the Exeter area is frost.

Ordinarily the frost period exists from December 10 to January 15 or 20. The Dofflemeyer Grove received some protection from freezing weather as it was equipped with wind machines and other protective devices. However, certain years have severe freezes, against which protective devices are ineffective. These severe freezes occur on an average of every 10 years. There was no frost damage to the navel orange crop in the Exeter area during the frost period of 1944-1945. However, during the 1948-1949 period the Exeter area experienced a severe freeze. That season Pogue lost all of the oranges upon 25 acres of the Dofflemeyer Grove which still remained on the trees at the time of the freeze. [R. 27, 28.] During the year 1944 there was no buying of fruit on the trees because the cash buyers, as they were called, ordinarily bought oranges for a particular market at a particular time and they could not achieve this under the prorated system. Taxpayer and her brothers were farmers and fruit growers and were in the business of producing and selling picked, ripe oranges (personalty). They were not in the business of selling orange groves; neither was it their business to sell immature fruit on the trees and they had never made such a sale prior to the sale here in question. [R. 74, 75, 94, 95, 122, 123.]

In operating the grove they followed the procedure of selling their oranges through the California Fruit Growers Exchange. This is a marketing organization which sells the pooled fruit of many growers on the eastern markets and remits to each grower his proportionate part of the average selling price received for the pool. More than 95 per cent of the orange crops in the Exeter area are sold through exchanges such as the California Fruit Growers Exchange. [R. 29, 30, 87, 88.]

Taxpayer and her brothers never contemplated selling their immature fruit on the trees in August of the year 1944 or in any other year. [R. 122, 123.] In the joint income tax return of taxpayer and her husband, she reported the sale of her one-third interest in the Dofflemyer Grove at a net gain of \$48,819.82, of which 50 per cent, or \$24,409.91 was included in their taxable income as a long term capital gain. The Commissioner determined that of the reported net gain of \$48,819.82 from the sale, \$40,833.33 represented taxpayer's one-third share of the fair market value of the growing crop of oranges on the trees and that such amount constituted ordinary income and not capital gain. [R. 30, 31.] The Tax Court held that of the gain reported by the taxpayer \$13,333.33 was allocable to the growing crop on the trees and that the same was taxable as ordinary income. [R. 31.] Two judges dissented. [R. 50-55.] The Court of Appeals for the Ninth Circuit affirmed the decision of the Tax Court. [R. 131-137.]

Specification of Errors.

1. The United States Court of Appeals for the Ninth Circuit erred in holding that the immature fruit on the trees on the date of sale of the orange grove was property held primarily for sale to customers in the ordinary course of trade or business, and in failing to hold that the same was real property within the purview of Section 117(j) of the Internal Revenue Code.
2. The Court further erred in deciding in the alternative that the six-month holding period of the immature fruit commenced when the parties decided to sell the property as a unit, rather than when the property was acquired.

Summary of Argument.

The taxpayer and her brothers were in the business of producing, picking and selling mature oranges. Sales were made through an exchange to eastern buyers. On September 1, 1944, the taxpayer sold her interest in the grove. At the time of sale the trees had upon them green, immature fruit, which would not be ripe or ready for picking until approximately three months thereafter. Except as a part of the real estate the immature fruit had no value. Its sale as picked fruit was prohibited by law. If severed at the date of sale of the grove the green fruit was worthless and would have withered and died.

California law, in line with the general rule, holds an immature, growing crop to be part of the real estate. Title to immature fruit passes to the buyer under a deed to the land, without any mention being made of the fruit. The immature fruit, being part of the trees, was part of the real property used in taxpayer's business of producing and selling ripe, picked oranges.

None of the property sold by taxpayer was held by her primarily for sale to customers in the ordinary course of her trade or business. Taxpayer was not in the business of selling immature fruit on the trees. The sale was a unit sale for a lump sum unallocated consideration of the real estate used in the trade or business of producing and selling mature, picked oranges (personalty).

The holding period of the property sold began on the date of its acquisition in 1941. The holding period of the immature fruit did not begin in May, 1944, at the time the offer was made by the taxpayer to sell the grove as a unit. The property in question was held for more than six months and its sale resulted in capital gain under Section 117(j) of the Internal Revenue Code.

Argument.

The taxpayer and her two brothers each owned an undivided one-third interest in a 115-acre tract of land, known as the Dofflemeyer Grove. On August 10 of the taxable year, the taxpayer and her co-owners entered into a contract for the sale of this property, together with improvements, water rights and the equipment thereon, for a lump sum consideration of \$197,100.00. The sellers had acquired the property on December 31, 1941, through liquidation of a family corporation. Deed to the buyer of the property was given on September 1, 1944, pursuant to the agreement of August 10, 1944, which treated the sale in its entirety as a sale of real property and made no allocation of the sale price. At the time of sale the orange trees had immature fruit upon them which had "set" (*i. e.*, reached the stage of adhering firmly to the tree), but which would not be mature and ready for marketing for a minimum of three months. The Tax Court, in its decision, allocated \$40,000.00 of the sale price to the ~~immature~~ fruit and held that the same should be taxed as ordinary income in lieu of capital gain. It is taxpayer's contention that the entire gain upon disposition of the grove was capital gain, within the purview of Section 117(j) of the Internal Revenue Code (26 U. S. C. 117(j)) and that the Tax Court and the Court of Appeals for the Ninth Circuit erred in treating any part of the gain as ordinary income.

The issue thus presented is whether the immature, unseparated orange crop is real property used in the trade or business of the taxpayer, or whether the same ~~is~~ real property separate and apart from the land and trees, held by the taxpayer *primarily* for sale to customers in the *ordinary* course of her trade or business, as contended by the

Commissioner. A consideration of the statutory provisions, as applied to the facts of this case, will show that the taxpayer is correct in her contention that it is property falling within the purview of Section 117(j) of the Internal Revenue Code.

As an alternative ground for its decision the Court of Appeals for the Ninth Circuit stated:

“Assuming this decision to sell the property as a unit changed the character of the holding of the crop, §117(j)(1) is not satisfied, for the crop was not held in the non-business sale character for the six months required by that section.”

We will demonstrate that such an interpretation of the statute is clearly erroneous.

I.

A Growing, Immature and Unsevered Crop of Oranges Under the General Rule and Under the Applicable California Law Is Part of the Real Property.

The general rule of the common law is that growing crops form a part of the land to which they are attached, and that they follow the title of the land unless there is an express reservation or exception to the contrary. (*Am. Jur.*, Vol. 15, p. 200; *C. J. S.*, Vol. 25, p. 7.) This rule is based upon practical consideration and good reasoning. The case of *McCoy v. Commissioner of Internal Revenue*, 192 F. 2d 486 (C. C. A. 10th), involved the sale of wheat lands having at the date of sale an immature wheat crop upon them. The Court of Appeals for the Tenth Circuit held that the gain on the sale of the immature crop was to be treated as capital gain, as a gain on the sale of real property under Section 117(j).

In commenting upon the nature of growing crops, the opinion of Judge Huxman at page 488, states:

“* * * In other words, Kansas treats growing crops as a part of the real estate to which they are attached and thus considers such crops as real estate.

* * * Growing crops depend for their life upon the real estate of which they are a part. They draw their food and sustenance therefrom. Separate them from the real estate and they cease to exist and die. Except as a part of the real estate, a growing immature crop has no value.”

The California courts from the earliest times have held that an immature, unsevered, growing crop of fruit on the trees is a part of the real estate, and, upon conveyance of the land title to the crop passes to the grantee. The decisions of the Supreme Court of California have consistently recognized the peculiar nature of growing crops and have held that they have no independent existence apart from the land to which they are attached and upon which they depend for nutriment. The following California cases support this rule.

Penryn Fruit Co. v. Sherman-Worrell Fruit Co., et al., 142 Cal. 643, 76 Pac. 484;

Huerstal v. Muir, 64 Cal. 450, 2 Pac. 33;

Wilson v. White, 161 Cal. 453, 119 Pac. 895;

Young v. Bank of California (1948), 88 Cal. App. 2d 184, 198 P. 2d 543.

It is a well-settled rule of statutory construction that the natural, ordinary and well-settled meaning of the words used in a statute will be adopted in the absence of a definite indication that Congress intended some other meaning. (*Helvering v. William Flaccus Oak*

Leather Co., 313 U. S. 247; *Lynch v. Alworth-Stephens Co.*, 267 U. S. 354.) The words "real property" in the phrase "real property used in the trade or business" in Section 117(j)(1) clearly were used by Congress in their ordinary and well-settled meaning as defined by the general rule of the common law and the law of California. Consequently, the growing, immature, unsevered crop as well as the trees and the land fell within the purview of Section 117(j) as real property.

II.

The Green, Unsevered, Immature Oranges Were Not and Could Not Be Property Held by the Taxpayer Primarily for Sale to Customers in the Ordinary Course of Her Trade or Business.

It is an axiom of tax law, often quoted, that "taxation is an intensely practical matter." (*Farmers Loan & Trust Co., Executor v. Minnesota*, 280 U. S. 204.) It has repeatedly been held that tax laws deal with actualities and are unconcerned with theoretical considerations. (See Mertens, *Law of Federal Income Taxation*, Vol. 1, Sec. 5.03.) This rule has been reiterated in the case of *Louise Owen v. Commissioner*, 192 F. 2d 1006 (C. C. A. 5th). That case involved the sale of orange groves with growing fruit on the trees. The majority of the fruit had matured but was not picked. The Court, in its opinion, stated (p. 1008):

"As in other problems of taxation, the approach here should be factual, not hypothetical."

In making this statement the Court was dealing with the argument of the Commissioner to the effect that had the taxpayer sold the grove to one purchaser and the fruit separately to another purchaser that in such event

she would have realized ordinary income. However, the Court pointed out that taxation follows the facts and that the transaction as it actually occurred furnishes the answer. It was held that taxpayer's ordinary business was selling citrus fruit as personalty, altogether severed from the realty, and that she was not in the business of selling groves. The Court said there was no sale of fruit as personalty, that the constructive severance made by the Commissioner for tax purposes was purely artificial. It was held that the growing fruit was not at the time of the sale property held *primarily* for sale in the *ordinary* course of taxpayer's trade or business.

Similarly, in the instant case the actualities of the sale made by the taxpayer should govern. Taxpayer was in the business of producing and selling picked, ripe oranges (personal property). She marketed her crop through the California Fruit Growers Exchange, which sold the crop to wholesale merchants in the eastern markets. She was not in the business of selling orange groves, nor selling green fruit on the trees. During their entire business experience, taxpayer and her brothers had never made a sale of fruit on the trees and had never sold immature fruit. In 1944, no sales of fruit on the trees, even when the same was mature, were made in the vicinity of Exeter, California, because of the Federal pro-rate system, then in effect. Also, Lewis L. Doffemyer, manager of the grove, testified that it was absolutely unheard of to sell oranges on the trees in August, because they were then in such an early stage of development [R. 122, 123].

At the date of the sale, the green, unsevered fruit was simply a part of the real property used in taxpayer's business of growing and selling mature, picked oranges.

It is undisputed that green citrus fruit severed from the trees has no commercial value; it is not inventoriable; its sale to consumers is prevented by law. It is absolutely dependent for its sustenance and support upon the tree of which it is an inseparable part. It differs little from the blossoms. Both represent only the prospect of future income; neither represent a crop which could be separated from the tree and marketed as such. The facts are that at the time the grove was sold taxpayer held no property primarily for sale to customers in the ordinary course of her trade or business. The ripe, picked oranges which would constitute property so held had not come into existence.

The immature crop was subject to hazards of insects, blight, wind and freezing weather, and might never survive to become a mature crop. On an average of once in ten years, the freezing weather in the Exeter area is severe enough to damage extensively or completely destroy an orange crop. The small green fruit increased the value of the grove, since it indicated that income, in the form of a mature, picked crop might be anticipated at a future date. This differs little from the anticipation that the living tree for an indefinite number of years in the future will continue to produce an annual crop, and it is from such anticipation that the orange tree derives all of its value.

It is evident that the sellers were selling an orange grove. They were not attempting to dispose of a crop. They offered the grove for sale through the real estate broker in May. At this time, there was no set crop of oranges upon the trees. [R. 80, 89.]. The co-owners never changed the price of the grove quoted to the real estate broker, and it was sold at the original asking price.

It is apparent that they were proposing to sell the grove as such, and attached no particular value to the immature fruit. In their dealings the sellers gave no recognition to the artificial severance of immature crop from trees which the Commissioner has proposed.

It is therefore evident that the trees and the immature crop comprised a single and indivisible whole, as real property used in the taxpayer's trade or business, none of which was held primarily for sale to customers in the ordinary course of her business.

III.

Decisions of the Tax Court and the Courts of Appeal Hold That Natural Products Attached to the Land and Not in Final Salable Form Are a Part of the Capital Investment, and Not Property Held Primarily for Sale to Customers in the Ordinary Course of the Taxpayer's Trade or Business.

The Tax Court and the Courts of Appeal have held that natural products attached to the land and not in final salable form are in their nature part of the capital investment and do not constitute "property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business."

The case of *Butler Consolidated Coal Co.*, 6 T. C. 183, involved a sale of lands containing veins of unmined coal by a taxpayer whose business was the mining and selling of coal. The Tax Court held that the unmined coal should be treated as a capital asset. At page 189 of its opinion the Tax Court said:

"The petitioner contends that the 'coal in place' in the Erico property was property held by the taxpayer primarily for sale to customers in the ordinary course

of its trade or business. The business of the petitioner was the mining and sale of coal—not the sale of coal which it had purchased from others, but the sale of coal which it produced itself. Coal in place is a part of the realty. It is a part of the realty as much as any fixtures on the property. The petitioner was not engaged in the business of selling real estate or 'coal in place.' We are of the opinion that the coal in place in the Erico property was not held by the petitioner 'primarily for sale to customers in the ordinary course' of its trade or business. *Cf. Carroll v. Commissioner* (C. C. A., 5th Cir.), 70 F. 2d 806."

Related cases have held the same with respect to a sale of standing timber by a taxpayer engaged in the business of cutting the timber, sawing it into lumber and selling the lumber. (*Carroll v. Commissioner*, 70 F. 2d 806; *Camp Manufacturing Co.*, 3 T. C. 467.) Similarly, an individual owning an oil-producing property and engaged in selling the oil, should he sell the entire property would not be required to treat a portion of his sales price representing the oil reserves in the ground as ordinary income from sale of the oil (that is, from sale of stock in trade). (*I. T.* 3693, 1944 C. B. at page 272.)

As far as taxation is concerned, there is in substance, absolutely no difference between the lumberman who owns timberland from which he produces logs which he cuts into boards to sell, the miner who owns coal lands from which he mines coal to sell, the oil man who owns acreage upon which he has producing oil wells, and the orchardist who owns an orange grove with immature oranges on the trees. All own land which produces substances which, when severed from the land, become per-

sonal property, which they then hold for sale in their trade or business. The value of the land to the lumberman depends, among other things, on the amount and kind of timber on it. In the case of the coal mine owner, the value of his land depends on the amount and accessibility of the coal discovered. As to the oil man, the value of his land depends on the amount of oil reserves discovered and the amount which his wells can produce. As to the orchardist, the value of his land depends on the kind of trees in his grove and the anticipation that successive crops will be produced. In all cases there is potential future income to be realized, but only if that product is severed from the land to sell. The lumberman must cut the trees into logs and run them through his sawmill; the coal miner must sever the coal from the vein and bring it to the surface and put in his coal bin; the oil man must pump the oil into his tanks; and the orchardist must pick his oranges when they mature and deliver them to the packing plant to be prepared for market. All produce personalty for sale when it is severed from the ground, which becomes their inventoriable stock in trade. All are in the business of selling personal property. They hold the personal property for sale to customers in the ordinary course of their trade or business only after it is severed from the ground. There is no ordinary income, actual or constructive, to be taxed until it is produced and severed from the land, or at the very earliest in the case of the orchardist, until the fruit attains maturity on the tree and becomes for the first time, farm produce. It is just as logical to tax the oil reserves in the ground as ordinary income in case of sale by the owner of oil property as it is to tax as ordinary income immature

fruit on the trees before the fruit is picked or harvested. The same can be said of the unmined coal in the pit, and the uncut timber in the forest. Why should the orchardist be singled out to pay a tax as ordinary income on unrealized potential income, while the others pay a capital gains tax when their land is sold? There is no reason for such a distinction. The tax on the sale of such real estate falls squarely within the purview of Section 117(j) and should be treated as a sale of a capital asset.

The Court of Appeals for the Tenth Circuit has applied this rule with respect to the sale of agricultural land with an immature, unsevered crop, *McCoy v. Commissioner of Internal Revenue* (1951), 192 F. 2d 486. The holding is summarized in the words of that opinion as follows:

"* * * McCoy was not engaged in the business of producing and selling immature crops of wheat. His business was that of producing, harvesting and selling mature grain in the ordinary course of business. It follows that no part of the transaction resulting in the sale of this land was an operation carried on in the course of his business of producing, harvesting and selling ripened grain. The sale was a unit sale of a piece of real estate used in his business of producing and selling grain. The real estate in question had been so used in the business for more than six months and the sale resulted in a capital gain."

The facts are analogous to the other real property sales set out above, and the holding, we submit, is unquestionably correct.

IV.

The Fact That Taxpayer Is Permitted to Deduct as Ordinary Expense the Cost of Cultivation and Care of the Grove to the Date of Sale Does Not Confer Any Unique Advantage Upon the Taxpayer; nor Is It a Reason for Denying to Her the Application of Section 117(j) as to the Entire Sale Proceeds.

Counsel for respondent no doubt will argue that since taxpayer and her brothers were permitted to deduct as ordinary expense approximately \$16,000.00, being the cost for the care of the grove from January 1, 1944, to September 1, 1944, the immature crop should be segregated and taxed as ordinary income. The deduction of expenses does not give the taxpayer any unusual or unique advantage.

For example, a taxpayer who sells at a profit a truck used for several years in a trucking business is permitted to charge off depreciation and expenses of repair and upkeep made on the truck during the year of sale against his ordinary income, while the gain, if any, is taxed as capital gain. That this construction of Section 117(j) is correct is not questioned.

A similar situation exists with respect to the sale of animals used by a farmer for breeding purposes in his business of producing and selling livestock. It is settled that the farmer may deduct from income all of his ordinary expenses of raising and caring for such breeding animals to the date of sale and that gain upon the sale, assuming such animals to have been held the required period, is long term capital gain. (*United States v. Bennett* (C. C. A. 5, 1951), 186 F. 2d 407.)

Coming to the expenses deducted in the instant case, it is evident that they fall into the same category. The sums expended by the taxpayer were for watering, fertilizing, fumigating, and other items necessary to keep the trees alive and healthy and to maintain the equipment which was sold with the grove. These annual expenses were necessary to keep the orchard going whether it produced a bumper crop or produced no crop at all.

It is evident from the foregoing that the sale of the land and the immature crop did not permit the taxpayer to escape tax, nor is there any suggestion that she was taking advantage of a loophole in the law. Taxpayer reported her entire gain upon the sale and has paid tax thereon at the alternative rate of 25 per cent.

V.

The Ruling of the Commissioner in 1946 Requiring an Allocation Between the Orange Grove and the Immature Fruit on the Trees Is a Misapplication of the Fragmentation Theory of Williams v. McGowan, 152 F. 2d 570.

For many, many years after the inception of the income tax law, the Commissioner never required that a farmer should segregate the immature crop from the land upon its sale, and treat the portion of the sale proceeds to be assigned to the crop as ordinary income. Indeed his prior rulings indicated that such an allocation could not be made. In *I. T. 1368*, I-1 C. B. 72, he stated that immature crops were not inventoriable property; the reason given is that the value and amount of such crops cannot be determined. This, we think, is in recognition of the fact that immature crops in themselves represent only pos-

able future income. It was not until the year 1946, that I. T. 3815, 1946-2 C. B. 30 was issued by the Commissioner. This ruling for the first time proposed to treat a part of the sale proceeds, representing some value of the growing crop, as ordinary income.

Although this ruling does not so state, it is apparent that it was inspired by the decision of the Court of Appeals for the Second Circuit in the case of *Williams v. McGowan*, 152 F. 2d 570, decided December 20, 1945. That case involved the sale of an entire business conducted as a sole proprietorship. While admitting that in the case of sale of a partnership interest, the sale would fall within the purview of the capital gain and loss provisions, irrespective of the nature of the assets comprising the partnership, the Court held that a different rule applied in case of the sale of a sole proprietorship business. In this latter situation, the majority held that the business must be comminuted into its fragments, and each fragment separately matched against the definition contained in Section 117. Judge Frank wrote a vigorous dissenting opinion in which he pointed out that the carving up of a going business into its parts was a purely artificial segregation, not recognized by the parties and not intended by Congress in enacting the 1942 Amendment to Section 117.

The incongruity of treatment between the sale of partnership and sole proprietorship interests, we believe, casts doubt upon the correctness of the holding in *Williams v. McGowan*, 152 F. 2d 570. Irrespective of its correctness, however, when applied to sale of a mercantile business with merchandise inventory as a principal asset, the ruling of the Commissioner that a similar segrega-

tion should be made between land, trees and growing crop, is an absolutely unwarranted extension of that doctrine.

The analogy of the inventory comminuted as a fragment of the business sold in the case of *Williams v. McGowan, supra*, is applicable to the picked mature oranges of the orange grower. However, this analogy loses its force and validity when it is extended to include a growing-crop which the law and practical reasoning both say is no more than part of the realty.

The green fruit represents only the prospect of future income. It does not differ from the anticipation that the grove will produce a large and profitable crop next year and in the years to come. The entire value of the orange trees at the date of sale is in the prospect of future income to be realized from the crop anticipated for the year 1944 and for subsequent years. If the prospect of income represented by the immature crop on the trees is to be segregated and taxed as ordinary income, does not the same logic require that the blossoms on the tree should be segregated and taxed as ordinary income, in the event the sale of a grove is made in April or May? Since the potential crops for 1945 and subsequent years are also present in the tree at the time of sale, represented by the leaves, bark, sap, and other parts of the living organism, should they not also be segregated and taxed? The fact that a producing piece of property is expected to yield ordinary income periodically in the future has never been the basis of taxing a portion of the sale proceeds of such property as ordinary income.

VI.

The Court of Appeals for the Ninth Circuit Misinterprets Section 117 of the Internal Revenue Code by Narrowly Construing the Term Capital Assets When It Is Evident That a Broad Construction Was Intended by Congress.

The Court of Appeals for the Ninth Circuit states that its conclusion is re-enforced because the purpose of the capital gain sections is to tax at special rates, rather than at ordinary rates, a realization of values which have accumulated over a long period of time, citing its previous decision, *Rollingwood v. Commissioner*, 190 F. 2d 263. Prior to 1942 Section 117 did provide that the holding period, in order to realize a long term capital gain, taxable at 50 per cent, was a period of two years, and to realize an intermediate long term capital gain taxable at $66\frac{2}{3}$ per cent was a period of eighteen months. If this had been the law in 1944, there would be some basis to support the statement of the Ninth Circuit Court. However, the Revenue Act of 1942 reduced the two-year and eighteen-month holding periods to a holding period of only six months. This was done at the same time that Section 117(j) was added to the Internal Revenue Code. The law as it now reads could not have been intended to apply solely to a realization of values which have accumulated over a long period of time. The statute specifically states that a long term capital gain is realized on the sale of a capital asset held for more than six months.

The lowering of the holding period to six months was to encourage sales of capital assets and thereby increase

the revenues. The Senate Finance Committee Report on the 1942 Revenue Act states:

"Your committee believes that the lowering of the holding period will have the effect of encouraging the realization of capital gains and thereby result in added revenue to the Treasury. * * *" (Senate Report 1631, 77th Cong., 2nd Sess., 1942-2 C. B. p. 545.)

It should be noted that the ruling of the Ninth Circuit in the instant case would seriously deter sales of orange groves, since the seller could never be sure of the amount of his tax liability resulting from such sales where an immature crop is on the trees. This would result from the difficulty of determining the amount to be allocated to the growing fruit. In the instant case the expert opinions expressed at the trial as to the value of the immature crop varied from a low of \$4,000.00 to a high of \$120,000.00. [R. 49.] Although the Commissioner in his ~~deficiency~~ notice contended for a value of \$122,500.00 for the crop, he has acquiesced in the Tax Court decision which found a value of \$40,000.00. [R. 50, 1951-1 C. B. 3.] Since the apparent purpose of Congress was the desire to facilitate sales, a holding which has the opposite effect is obviously in error.

Congress has consistently manifested its intent that the term "capital assets" be broadly construed and the exceptions to the definition narrowly construed.

Subsection 117(a)(1) defines "capital assets," excluding therefrom "property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business." This language was carried over into Section 117(j). Originally, the exclusion appeared

without the underlined words which were added by the Revenue Act of 1934. The Committee Reports on the Revenue Act of 1934 make it clear that the purpose of the amendment was to narrow the exclusions as they previously existed, thereby giving the broadest possible scope to the term "capital assets." The amendment was made during the depression years and its evident purpose was to prevent tax avoidance arising from offsetting of losses on sales of property against ordinary income, by bringing more losses within the scope of capital loss limitations. The following excerpt from the Committee Reports reprinted in Cumulative Bulletin, 1939-1 Part 2 show that the interpretation referred to above was intended (Senate Report, p. 595):

"Second, the definition of capital assets has been slightly revised to prevent tax avoidance by excluding from the category of a capital asset 'property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business,' instead of merely 'property held by the taxpayer primarily for sale in the course of his trade or business.'"

See also the Conference Report at page 632 which indicates that as a result of the amendment it would be impossible to contend that a stock speculator trading on his own account is not subject to the provisions of Section 117.

Likewise the Tax Court recognized that such a result was intended. In *Camp Manufacturing Co.*, 3 T. C. 467, 474, it was stated:

"* * * The words emphasized above ['to customers' and 'ordinary'] were added to section 117(a)(1)

by the Revenue Act of 1934. It is apparent that their inclusion narrows the scope of the exception as it previously existed. * * *

It is clear that Congress intended a broad construction of the definition of "capital assets" rather than the narrow definition adopted by the Court of Appeals for the Ninth Circuit in the instant case.

Further insight into the Congressional intent as to the meaning of the term "capital assets" is to be gathered from Section 323 of the Revenue Act of 1951. This section expressly provides for capital gain treatment in the case of an unharvested crop, if the crop and land are sold together.

The Committee Report (Senate Report No. 781, Eighty-second Congress, First Session, printed at 1951-2 Cumulative Bulletin, p. 458 at p. 492) of the Senate Finance Committee, we believe, clearly shows the Congressional understanding of the law that such transactions did not fall partially beyond the scope of Section 117(j) of the Internal Revenue Code. After reciting the conflict which has arisen in the case of the sale of agricultural land with an unsevered, immature crop, the report contains the following significant language:

"Your committee believes that sales of land together with growing crops or fruit are not such transactions as occur in the ordinary course of business and should thus result in capital gains rather than in ordinary income. * * *

This statement of the Committee expresses unequivocally its opinion that sales of land with growing crops were not and are not sales in the ordinary course of

business. The Committee Report would seem to say that the 1951 Revenue Act did not create a new status for unharvested crops; it merely clarified the intent of Congress that Section 117(j) should apply. The Court of Appeals for the Ninth Circuit chose to find the intent of Congress from the Committee Report that the 1951 amendment was a change of law, rather than a clarification. It based this finding upon the grounds that the amendment was not expressly made retroactive and that the Committee Report referred to a loss of annual revenue resulting from the amendment. The failure of Congress to make the 1951 amendment retroactive, when considered in the light of the above-quoted statement of the Committee, appears to mean no more than that Congress saw no necessity of doing so. Prior years are taken care of by the statement of the Committee that such sales are not in the ordinary course of business.

Respecting the annual loss of revenue referred to, it would appear that this is a loss in revenue resulting from Congress making clear its intention that Section 117(j) always was applicable to unharvested crops, sold with the land to which they are affixed. At page 488 (1951-2 C. B. p. 488) the Committee Report deals with the 1951 amendment respecting gains from the sale of livestock held for draft, breeding or dairy purposes. This section was expressly made retroactive. However, the report contains a similar statement that the revenue loss under this provision is expected to be \$15 million in a full year of operation. It is evident that the statements as to revenue losses refer to past as well as future years and do not indicate that a change in the law, rather than clarification, was being effected.

VII.

The Holding Period of the Immature Crop, as an Indivisible Part of the Trees to Which It Was Attached, Began on the Date of Acquisition of the Grove, and Not at the Time It Was Decided to List the Property for a Unit Sale as Stated by the Ninth Circuit.

In its opinion the Court of Appeals, Ninth Circuit, assumes that the intent to sell the grove as a unit made the holding of the orchard and crop a holding for a sale not in the ordinary course of any business of the taxpayer. It goes on to state that in such event this property would not have been held for the required six months, since the decision to sell was made in April or May and the sale was completed on September first of the same year. The Court errs in stating that the holding period began with the decision to list the grove as a whole with a real estate broker. There was no conversion of the property on that date nor any acquisition from which a holding period would begin to run. The basis of the property was unaffected. Respecting the time at which the holding period of a particular piece of property begins to run, this Honorable Court, in the case of *McFeely v. Commissioner of Internal Revenue*, 296 U. S. 105, stated at page 107: °

“In common understanding to hold property is to own it. In order to own or hold one must acquire. The date of acquisition is, then, that from which to compute the duration of ownership or the length of holding. * * *

The taxpayer here held the orange grove from January 1, 1942, to September 1, 1944, a period in excess of six months. [R. 20, 22.] The Commissioner's own witness, Pogue, testified that he considered that the new crop started off in December of one year or January of the second year and that by the first of September there had been eight months toward the development of another crop. [R. 111.] Consequently, whether it is considered that the property sold was acquired on January 1, 1942, or only at the starting of the new crop, the period of holding in either event was in excess of six months. We believe that the correct rule is that the holding period runs from the date of acquisition of the land and trees since the immature crop is an inseparable part of the land prior to maturity and represents only the prospect of or potential future income.

It is submitted that the courts should look at the transaction which actually took place in determining the nature of the sale. However, it is an unwarranted addition to the law to hold that the holding period for a sale not in the ordinary course of the taxpayer's business begins only on the date that an intention is formed to make such a sale if a buyer could be found. The incidents of tax laws turn upon more substantial ground than this.

Conclusion.

The petitioner, M. Gladys Watson, and her brothers were engaged in the occupation of producing and selling mature ripe oranges. They were not in the business of

selling real estate. The immature, unsevered fruit is a part of the real estate. The sale by petitioner and her brothers of the grove with immature, unsevered fruit on the trees does not represent the sale of property held primarily for sale to customers in the ordinary course of trade or business. The holding period of the immature fruit as a part of the realty began on the date the grove was acquired in 1941, and therefore was a period in excess of six months. The entire transaction falls within the purview of Section 117(j) of the Internal Revenue Code, and the gain should be treated as a capital gain. The decision of the Court of Appeals for the Ninth Circuit should be reversed.

Dated January 12, 1953.

Respectfully submitted,

A. CALDER MACKAY,

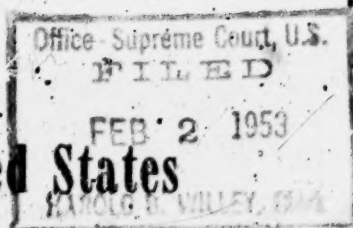
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IN THE
Supreme Court of the United States

October Term, 1952

No. 290

ERNEST A. WATSON and M. GLADYS WATSON,

Petitioners,

v.s.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

On Writ of Certiorari to the United States Court of Appeals
for the Ninth Circuit.

REPLY BRIEF FOR THE PETITIONER.

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REPLY BRIEF FOR THE PETITIONER.

Introduction.

The brief for the respondent is founded upon one premise which when it is accepted, the conclusions drawn in the brief follow as a matter of course. The assumption is that the immature fruit on the trees actually was an existing fruit crop. Such was not the case. The green globules upon the tree similar to the blossoms and the other parts of the living tree were no more than the evidences or expectancy of a mature crop which would come into existence at its earliest some three or four months in the future. The parties made a lump sum sale and the Tax Court erred in concluding that the parties were dealing with a crop of fruit as such. Each party had in mind the

expectancy of the crop anticipated for the year 1944 as well as the annual crops for subsequent years. It was with the *expectancy* of a fruit crop that the parties dealt and not with a crop as such.

Counsel for respondent states that the Tax Court found as a fact that the immature crop was being held primarily for sale to customers and further that such a holding is ordinarily a fact question (Br. 26). The findings of fact of the Tax Court do not contain this statement. The reference in the brief of the respondent [R. 47] is to a statement in the opinion which appears to be based in part upon the assumption made by the Tax Court that farmers generally treat their crops from the time they come into recognizable existence as something apart from the land. The cases cited in respondent's brief (Br. 26) involved the fact question as to whether or not the sales activities of the taxpayer constituted a trade or business, a question which is not present in the instant case. We submit that the question here presented is principally a question of law involving the proper construction of Section 117(j).

I.

Under the Law of the State of California and a Vast Majority of the Other States, the Growing Crops Are Held to Be Part of the Real Property Where a Conveyance of the Real Estate Is Made.

The respondent in his brief points to a supposed variety of views among the states and in California as to whether a growing crop is real property or personal property and suggests this as a reason for disregarding the law of California (Br. 34, 35). Insofar as the State of California goes, the decisions have uniformly and consistently held that under the facts in the instant case, *i. e.*, a con-

veyance of land without any mention or reservation of a crop, that the crop partakes of the nature of the realty and for that reason passes to the purchaser under the deed. The fact that under certain circumstances not involved in this case a growing crop may be treated as constructively severed from the land and treated for limited purposes as personal property, can have no bearing here. The only exceptions in California law referred to in the opinion of the Tax Court [R: 33-41] were cases involving chattel mortgages where, by express statutory provision, the growing crop can be mortgaged as a chattel. That a growing crop is treated differently for such purposes is immaterial when the transaction under consideration is a sale of real estate. Respecting the law of other states, the Tax Court refers to only three states which do not follow the general rule, and in all except Georgia, it appears that where the facts involve a conveyance of land, that the growing crop passes under the conveyance as part of the real property. It is not controverted that under the general law of the vast majority of the states growing crops pass under the deed of conveyance as part of the realty. Corpus Juris Secundum, Vol. 25, page 7, states:

"The general rule is that crops attached to the land at the time of a sale or conveyance of the land so far partake of the nature of realty that they pass to the purchaser by the sale or conveyance as appurtenant to the land, unless they are reserved or excepted, as is stated in §7 *infra*, or are covered by certain exceptions known to the law, such as a severance by deed or other valid contract, or mortgage, or as being the crops of tenants. * * *

4

II.

The Long Continued Silence of the Commissioner of Internal Revenue Indicates It Was the Administrative Policy That No Allocation Between Trees and Growing Immature Crop Should Be Made and That Such Sales Should Be Treated as Sale of Capital Assets.

Respondent's Brief (Br. 42) indicates that the taxpayers first began to urge that capital gain treatment was extended to growing crops after enactment of Section 117(j) of the Internal Revenue Code enacted as a part of the Revenue Act of 1942. It is true that for a period of four years, from 1938 to 1941, Section 117(a)(1) of the Internal Revenue Code excluded from the definition of capital assets, depreciable property, and for those years it is evident that a taxpayer could not assert a capital gain with respect to the sale of an orange tree (depreciable property) or any of its component parts. However, the capital gain provisions have been in the statute ever since 1921 and the definition of capital assets included both land and improvements held for business purposes. Therefore, if the Commissioner's policy was to require an allocation between land and trees and growing crop, he should have so ruled shortly after the adoption of the Revenue Act of 1921 when the problem would first be presented, and not in 1946 when he issued his ruling (*I. T.* 3815, Cumulative Bulletin 1946-2, p. 30). - (Note: ruling applies only to oranges—no apparent statement on other crops.) The long continued silence of the Commissioner indicates that no allocation between trees and crop was ever intended. This is further borne out by the ruling of the Commissioner, *I. T.* 1368, Cumulative Bulletin I-1, page 72, where the Commissioner ruled that a growing crop is not in-

ventoriable for the reason that the amount and value of such crops cannot be determined. His long continued silence on this question shows that it was the administrative policy not to tax the immature crops at ordinary income tax rates but rather as a part of the trees, a capital asset.

III.

The Green Unsevered, Immature Oranges Were Not and Could Not Be Property Held by the Taxpayer Primarily for Sale to Customers in the Ordinary Course of Her Trade or Business.

The real issue in this entire proceeding is whether the seller sold and the purchaser acquired the immature fruit as a crop of oranges. Respondent's Brief is built upon the premise that this is the transaction which took place. The brief argues that this must follow principally from the evidence in the record that Pogue was induced to purchase the entire property because he estimated he would be able to sell the current season's crop of oranges for some \$120,000.00, and it was therefore apparent that these oranges were an important item or element in the lump sum transaction. Respondent therefore concludes that it must be assumed that the immature crop was sold by petitioner and purchased by Pogue *as a crop of oranges*.

On September 11, 1944, petitioner gave a deed to Pogue which described the land, but made no mention of either the trees or the immature crop. The deed merely described the land.

The green globules then on the trees, which evidenced that a crop of oranges might later be produced, were as much a part of the trees as the leaves. Chemically, they were similar to the leaves, and, to some extent, functioned

like the leaves in sustaining the trees. Also, like the leaves, and the other component parts of the trees, they had no present value, except, and unless, they remained attached to and a part of the trees for some three to four months longer; and they would never have any value, at any time in the future, unless weather and other unforeseeable conditions were such as to enable them to mature and become oranges.

It is, therefore, clear that, under the law of California, the immature crop passed to the purchaser, not because it was sold *as a crop*, but in like manner and for the same reason as did the leaves, the branches, the roots and the other component parts of the trees. It is also clear that these globules did not have a separate or intrinsic value, *in and of themselves*, which would justify the conclusion that a part of the lump-sum consideration was paid for, their purchase, *as a crop*, ~~what is~~ as something separate and apart from the other component parts of the trees.

In fact, the only thing of value, insofar as these globules are concerned, and which, therefore, could have been the subject of a separate bargain and sale, was the *expectancy* that they would later become a marketable product, to-wit: oranges. And, plainly, at the date the grove was sold, these green globules had not matured to the point where it could be said, in any proper sense, that they were "oranges." Oranges are defined by Webster's New International Dictionary as: "The nearly globose fruit of certain trees"; and "fruit" is defined as: "The edible * * * product of a perennial or woody plant." The globules, which constituted the immature crop here, were still an integral part of the trees—not an "edible product," nor even a "product," which those trees had already produced.

A. The Fact That the Crop Expectancy Constituted an Item of Value in the Lump-sum Sale Does Not Mean That Petitioner Therefore Was Selling a Crop of Oranges.

If the globules had reached the stage of maturity where they were oranges, then they would have had a value in their own right, and would, for tax purposes, have been considered as a separate property, irrespective of whether they were, or were not, so classified under California law.

However, the Tax Court does not contend that these globules had reached that stage of maturity. While it refers to them as "oranges", yet, it concedes that the crop was immature. But it nevertheless concludes that the globules, which constituted that crop, were sold as a crop of oranges, because:

"* * * in the instant case the oranges, exclusive of the land, trees and improvements, did in fact constitute a distinct and important item or element in the lump sale which occurred * * *." [R. 44.]

And,

"During the negotiations * * * (it was) estimated that the crop on the trees would be approximately 70,000 loose boxes of oranges, *normal crop conditions thereafter being granted.*"¹ [R. 44, 45.]

And, because

"As far as Pogue was concerned, the quantity and condition of the oranges, plus the price anticipated when the crop should reach maturity, supplied to him the controlling inducement for buying the entire property at the price paid, and for cash." [R. 45.]

Thus, it is plain that the Tax Court takes the position that there was a "short" sale of an as-yet-unproduced crop of oranges.

¹Emphasis supplied.

There can be no doubt that the expectancy that these globules would later become marketable oranges induced Pogue to pay \$197,100.00 for the "entire property," including the grove. That is evidence by the fact that, shortly before he made the purchase, he had estimated that the trees would produce approximately 70,000 loose boxes of oranges, and, upon the basis of that estimate, had figured he would recoup some \$120,000.00 of his investment from the sale of those oranges. And this fact, coupled with the fact that he had declined to pay the same price for the grove in June, amply warrants the conclusion that the value he placed upon the crop expectancy induced him to pay substantially more for the property than he would have paid without that expectancy. But, clearly, these facts are not determinative of whether (a) he invested that excess in the immature crop, *as a crop of oranges*, or (b) whether he invested it in the grove, *i.e.*, the *land and trees*, because of their current crop expectancy. In other words, these circumstances merely show the inducement for the lump-sum purchase—not whether, in and by that lump-sum transaction, there was a bargain and sale of the immature crop, as such. And, under these circumstances, it certainly could not be said, as the Tax Court does, that "Pogue was buying oranges" and that petitioner and her brothers "were selling their crop of oranges for cash in hand." [R. 45.] Obviously, if the crop, as a crop, was a subject of the barter and sale, it was the *immature* crop which was being bought and sold—not "oranges" or a "crop of oranges," which was not presently in existence, and which might never come into existence.

Nor is the fact that "the oranges, exclusive of land, trees and improvements, was a distinct and important item or element in the lump sale which occurred" [R. 44],

determinative of whether the crop was sold, either as an immature crop, or as a crop of oranges yet to be produced. While here again the Tax Court speaks of the immature crop as though it had already matured and become oranges, yet, what it means, or should mean upon its own findings of fact,² is that the expectancy that the trees would produce oranges was an important "item or element in the lump sale." By referring to this *expectancy* as "oranges", it implies that it *must* be assumed that the immature crop was sold as oranges, whereas the facts do not support the conclusion that there was a bargain and sale of the crop, even as an immature crop, much less as a crop of *oranges*. For example, it takes two to make a sale, and it is evident that petitioner was not selling oranges. True, petitioner agreed with Pogue in respect to the "quantity and condition" of the oranges the grove could be expected to produce, "*normal crop conditions thereafter being granted.*" But she did not grant that crop conditions thereafter would be *normal*. In fact upon the basis of her past experience with the grove, she anticipated that "crop conditions" *would not be normal*. She thought it probable that frost would kill, or materially damage, the immature crop before it could mature and become *oranges*; and it was only on that account that she was still willing to sell the grove to Pogue in August for the same price the real estate broker had offered it to him in June, some two months earlier. Certainly, she would not have done this if she and Pogue had been bargaining over the sales of oranges, because it is evident that the chance that the grove would bear a crop of oranges was greater in August than it was in June.

²"Navel oranges in the Exeter area generally mature and are ready for picking early in November." [R. 26.] The lump-sum transaction occurred three months earlier, on August 10.

In other words, under the circumstances here, the fact that petitioner and Pogue estimated the quantity and quality of the oranges, *which might be produced*, does not warrant the Tax Court's assumption that they must have agreed upon the value of the crop expectancy (which it calls "oranges") and that they must, therefore, have included the amount so agreed upon in the lump-sum consideration as the sale price of the crop. And there is not even any contention that they did that. The only point the Tax Court makes is that Pogue was induced, by his *unilateral* appraisal of the value of the crop expectancy to buy the "entire property" in August at the same price at which he refused to buy it and at which it was offered to him in June [R. 21-22].

The foregoing circumstances merely show that the difference of opinion between the parties, as to what crop could be anticipated, was the only reason they were able to agree upon a sale price for the "entire property." Yet, as pointed out above, the Tax Court implies that these facts support its conclusion that there was a bargain and sale of the crop expectancy (or rather, the green globules which evidenced that expectancy), *as a crop of oranges*. Under these circumstances, it is an anomaly to conclude that the parties bought and sold a crop of oranges, when the actual motivation for the bargain was the *uncertainty* as to whether a crop of oranges would, in fact, *ever be* produced. It is clear there was no mutuality or meeting of the minds of the parties as to the sale of any crop. As indicated above, the seller anticipated a freeze whereby there would be no crop, whereas the buyer was willing to take a chance and thought from his unilateral appraisal that the crop would be worth \$120,000.00 to him.

Clearly, this conclusion is not tenable. And the fact that Pogue's unilateral appraisal of the current season's crop expectancy induced him to buy the "entire property," and pay more for it than he otherwise would, certainly does not warrant the conclusion that he purchased the immature crop, as a crop—much less that he purchased it *as a crop of oranges*. For example, suppose Pogue had shared petitioner's view with respect to the likelihood that this immature crop could never mature on account of frost. And suppose also he had thought there would be a bumper crop of oranges, and very high prices, the *following* season. And, assume further that this conclusion upon his part induced him to buy the grove, and pay "X" dollars more for it than he otherwise would. In that event, would the Commissioner contend, or the Tax Court hold, that petitioner had had a crop realization for the *following* season, because, in Pogue's opinion, the speculative value of the crop expectancy for that season was "X" dollars, and because that fact had induced Pogue to buy the grove? Or, suppose Pogue had overestimated the quantity of the current crop of oranges, or the price he would receive for them, some three months later when and if they became oranges. In that event, would the Commissioner have approved a loss deduction to Pogue upon the ground that he (Pogue) had not recovered as much of his investment in the "entire property" as he had anticipated?

Or, looking at the cases of *Isaac Emerson*, 12 T. C. 875, and *Fawn Lake Ranch Co.*, 12 T. C. 1139, which the Tax Court rejected as having no relation to the instant case, suppose a taxpayer, who was in the business of selling cattle, culled from his breeding herds, certain

cows and offered them for sale. Suppose also that certain of those cows would give birth to calves in about three months, "*normal (physiological) conditions thereafter being granted.*" Also assume that the purchaser was induced to buy those cows because he expected to recover most of his investment from the sale of the calves when, and if, they were born. In that case, would the Commissioner contend that a portion of the sales price of the cows should be allocated to the non-existent calves, merely because the cows were expectant mothers? Or, if the normal conditions, upon which the purchaser had relied, had not happened and some, or all, of the calves had not been born, would the Commissioner allow the purchaser to deduct a loss because he (the purchaser) had thought that he would recover a part of his investment in the cows from the sale of the calves, when and if they were born? And would his rights, or those of the seller, have been any different by reason of the fact that he had set up on his books, as the cost of such unborn calves, the amount which, in *his opinion*, represented the speculative value of the cows' pregnancy?

These examples make it clear that the *inducement* is not determinative of *what* was purchased. And the following example will even more clearly illustrate the fact that the purchase price must be allocated to the property which is purchased, rather than to the inducement which motivated the purchaser to enter into the transaction. For example, suppose a taxpayer purchases a hotel site because of the scenic view that lot will afford, the hotel he

intends to build; and suppose he pays \$1,000.00 more for the lot because of that view. Clearly, he acquires the scenic view, which induced him to purchase the lot. And it is equally clear that he paid \$1,000.00 for that view. But, nevertheless, the total consideration is allocated to the lot, as its cost, because there could be no doubt, in such case, that he purchased the lot *because* of its view. In other words, the scenic view merely *appreciated the value of the lot* to the extent of \$1,000.00; and, insofar as the seller is concerned, that appreciation was realized from the sale of the lot—not the view.

It is plain, therefore, that if Pogue purchased the land and trees because he expected the trees to bear a crop of oranges some three months later—and, in effect, that is what the Tax Court finds—then the additional amount he paid on account of that crop expectancy represents appreciation, which petitioner realized from the sale of such land and trees—not the cost of the non-existent crop of oranges from which Pogue expected to recover a part of his investment.

The immaturity of the crop is, of course, necessary to this conclusion, because, if the crop on the trees had reached the stage of maturity, where, for all practical purposes, its harvest was assured, then, in that event, even though it went with the grove as a part of the real estate, there would nevertheless have been a crop realization for tax purposes. This would be true, because, as the Courts have repeatedly pointed out, taxes are levied upon the basis of substance, rather than form; and conse-

quently, since Pogue and petitioner, in that case, would, in reality, merely have been "trading dollars," insofar as a *mature* crop is concerned, it would necessarily follow, from a tax viewpoint, that petitioner had realized the fair market value of her crop, in and through the sale of the "entire property"; and that Pogue had invested that amount in a crop of oranges. In other words, the mere fact that the crop, for all practical purposes, had already matured and *become oranges* would have constructively severed those oranges from the trees, (quite irrespective of whether or not, under California law, they remained a part of the realty). And because of such constructive severance in a lump-sum transaction such as there was here, it could not be questioned that a part of the lump consideration had in fact been paid for the purchase of the crop, as oranges.

But where, as here, the crop had not reached maturity, and where it was purely a matter of speculation as to whether it ever would reach maturity, it must be held, for the purposes of tax law, that there was no sale of the crop, *as a crop*, just as, in the absence of a crop reservation in the deed of conveyance, it is held, for the purposes of conveyancing law, that the crop passed *as a part of the trees*.

It seems clear, therefore, that the Tax Court erred in holding that \$40,000.00 of the lump-sum was realized from the sale of a crop of oranges. The expectancy of such crop merely appreciated the value of the grove, and that expectancy, which went with the grove, merely induced Pogue to purchase the "entire property."

B. The Crop Expectancy Is Appreciation in Value of the Land and Trees. The Internal Revenue Code Precludes Allocation of This Speculative Value to the Current Crop.

This brings up the question whether for tax purposes, the appreciation which this expectancy gave to the grove, *i. e.*, to the land and trees, should be allocated to the current crop, notwithstanding that it passed to the purchaser *as a part of the realty*. The land and trees also passed to the purchaser as a part of the real estate described in the deed, and since a separate cost basis must, nevertheless, be allocated to each of those properties, it may be asked why the same should not be true with respect to the crop, which, like the land and trees, passed to the purchaser as a part of that same real estate?

The answer is that the Internal Revenue Code requires that an allocation be made as between the land and trees, because the land is non-depreciable and the trees are depreciable property. But, there is no provision in the Code requiring an allocation as between the component parts of the trees.

In fact, under the provisions of the Code, no such allocation could be made—at least logically. This is true because the current crop expectancy, which induced the purchase here, differs from the crop expectancies for subsequent seasons only in the amount of its speculative value; and that is difference in *degree*—not in *character*. The current expectancy, which the Tax Court erroneously calls "oranges," did not come into existence in May when

the trees bloomed. The expectancy that the trees would bear oranges during the current season, as well as in all other seasons, came into being years before when the trees themselves reached bearing age, and their healthy condition evidenced that they could be expected to bear oranges, each and every season, "*normal crop conditions thereafter being granted.*" At that time, and with such crop conditions *being granted*, experienced fruit growers could estimate the quantity and quality of the oranges, the trees could be expected to bear each and every season during their useful lives. The appearance of the blossoms in the current season, the later "setting" of the crop and the still later appearance of the green globules merely evidenced the extent to which crop conditions had been normal during the current crop season. And, because crop conditions had been normal that season, certain of the crop hazards had been successfully passed, and, therefore, the probability that the current crop would mature and become oranges was greater. This fact, coupled with the fact that harvest time became nearer with the happening of each of those events, merely gave the crop expectancy a progressively higher speculative value. But none of these events changed its character. It still was, and would remain, only an expectancy until the harvest of the current crop was assured. It follows, therefore, that being the same in character as crop expectancies for subsequent seasons, the current crop expectancy should be treated the same as the crop expectancies for succeeding crop seasons. If, however, a speculative value is as-

signed to the current expectancy and allocated to the immature crop, as its sale price, then, by the same token, the speculative values of the expectancies for subsequent seasons should likewise be allocated to the crops for those seasons as their sales prices. However, since the trees themselves have no value, save and except that which is derived from the sum total of their crop expectancies, this would result in the entire sales price of the grove being allocated between the land and the several crops the trees were expected to produce; rather than between the land and the trees, as the Code provides. If this were done, the part of the sale price not allocated to the land would be recovered by the purchaser in *unequal* amounts³ over the useful life of the trees, either (a) as crop losses, or (b) as cost deductions from crop realizations—not, as the Code provides, by *equal* depreciation deductions over the useful life of the trees.⁹ Hence, in effect, the Code precludes, rather than provides for, the allocation of the speculative value of the current crop expectancy to the current crop.

It seems clear, therefore, that the current crop expectancy was not sold as a crop of oranges. It merely gave the land and trees a greater value than they otherwise would have had. And, therefore, the amount Pogue paid because of that potentiality represents appreciation which petitioner realized from the sale of those assets.

³Each successive season's crop expectancy has a lesser present speculative value than the expectancy for the next preceding season.

C. The Green Globules on the Tree Were Neither Inventorial Property nor of the Kind or Character of Property Which Petitioner Held Primarily for Sale to Customers in the Ordinary Course of Her Trade or Business.

But even if, for purposes of argument, we assume that the speculative value of the current crop expectancy should be allocated to the immature crop, nevertheless, the amount so allocated could not be classified as ordinary income. As has been pointed out above, the globules which constituted that crop were not the kind or character of property which petitioner held primarily for sale to customers in the ordinary course of her trade or business, and, admittedly, they were not property of a kind which would properly be includible in her inventory. And the Tax Court, in effect, concedes these facts.

There were two phases of petitioner's business. *First*, she owned and operated her grove for the purpose of producing oranges in and through the care, maintenance and cultivation of such grove. *Second*, she was in the business of selling those oranges after, but only after, her grove produced them. Clearly, therefore, until oranges were produced, petitioner was holding her immature crop as a part of the trees for the sole and only purpose of producing the oranges, which when mature she thereafter began holding them for sale. And, to paraphrase the Tax Court's language, we are unable to see how the holding of the immature crop primarily for the purpose of producing the only marketable article petitioner was in the business of selling could be changed to a holding

for some other purpose in and by the sale of the assets, which were being used to produce such marketable product.

The lump sale transaction merely changed the ownership of the grove without working any change in the character of the crop. As a result of that transaction, Pogue continued to hold the same immature crop for the same purpose for which petitioner had previously held it, namely, for the purpose of using the assets, which he had purchased, to produce the mature oranges, and hence, the income, the prospect of which had induced him to purchase those assets.

While it is plain that Section 117 refers to the kind or character of the property, which is the subject of the holding, and not to the mode or manner of its sale, and while it is also plain that the fact that such property is real estate is not determinative of whether or not it is held for sale, yet, neither of those principles is violated here when a lump-sum sale is made of the grove, which carries the immature crop with it as a part of the trees. These transactions merely determine *what* property is to be considered in respect to the question of whether it is the kind or character of property which petitioner holds primarily for sale. And that question is then determined by comparing that property with the properties which petitioner has in the past held for sale in the ordinary course of her trade or business.

It is plain, therefore, that California law is determinative of the issue here, because, under that law, there

was no sale of the crop, as a crop of oranges. Under California law, the immature crop passed to Pogue as a part of the trees, and, therefore, if any income is realized by petitioner, in and from the speculative value of the current crop expectancy, the amount so realized must be allocated to the property which actually passed under California law, namely, the *immature* crop.

It follows that, even if there were a crop realization, such realization was from the immature crop, which was an integral part of the trees. Admittedly, the trees and land were used in the first phase of petitioner's business, and, since the Tax Court concedes that petitioner was not in the business of selling her immature crops, the immature crop here in question was not the kind or character of property which she held primarily for sale to customers. Hence, even if there were a crop realization, the income so realized is capital gain under Section 117(j).

The Court of Appeals, Ninth Circuit, followed the majority opinion of the United States Tax Court. It failed to recognize that petitioner's activities were dual in nature: First, she owned and operated her grove for the purpose of growing ripe mature oranges, and secondly, she was in the business of selling these oranges after her grove had produced the mature fruit; that the land and the trees (including all of its component parts—the roots, trunks, leaves, and little green globules) used in her trade or business were sold to Pogue for a lump sum before she had any fruit to sell in the ordinary course of her business of selling ripe mature oranges. The Court

of Appeals followed the fallacious theory that the immature fruit was a crop of oranges being held for sale, and assumed for some unexplained reason that as soon as there was some tangible evidence that there would be a potential crop, that such potential crop immediately became property held for sale to customers. As a matter of fact, the immature fruit was worthless at the time and would not be salable property for three or four months after the grove was sold to Pogue. The Court of Appeals further assumed that the decision to sell the grove as a unit apparently changed the character of the holding of the crop and that Section 117(j)(1) was "not satisfied for the crop was not held in the non-business sale character for six months required by that section," without stating when the holding period started or how the "character of the holding of the crop" was changed.

There was a potential crop on the trees when the unit sale of the grove was made—the same potential crop was on the trees after Pogue purchased it. The character of the property never changed. The immature crop was a part of the real estate until three or four months later when it matured and was picked by Pogue. Petitioner held the land and trees with all of its component parts for use in her business of growing and selling mature oranges. She held no fruit for sale to customers up to the time the unit sale was made to Pogue.

It is obvious that the land and the trees, including the immature fruit on the trees is property used in the peti-

tioner's business of selling mature fruit, and the profit realized on the sale thereof is entitled to the capital gains treatment under Section 117.

IV.

All of the Property Sold by Petitioner Was Held for More Than Six Months.

The final point made in respondent's brief is in the alternative that the green globules on the tree which counsel for the respondent call "the existing orange crop" were not held by taxpayer for more than six months. As has been previously pointed out, the existing orange crop came into being in November and December of 1944 when the fruit matured, after petitioner had disposed of her interest in the grove. Prior to that time the crop had no existence. The blossoms and the green globules were not a crop, and consequently a holding period could not commence from the date upon which they appeared on the tree or at the time petitioner listed the property for sale with the real estate broker. These component parts of the tree were used by taxpayer in the growing or producing phase of her business, and the holding period is the holding period for the land and the trees which the respondent concedes was a period in excess of six months.

Conclusion.

For the reasons set forth herein and in the opening brief of petitioner, the decision of the Court of Appeals is erroneous and should be reversed.

Dated January 30, 1953.

Respectfully submitted,

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Of Counsel.

Service of the within and receipt of a copy thereof is hereby admitted this.....day of January, A. D. 1953.

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In the Supreme Court of the United States

OCTOBER TERM, 1952

ERNEST A. WATSON and M. GLADYS WATSON,
Petitioners

v.

COMMISSIONER OF INTERNAL REVENUE

On Petition for a Writ of Certiorari to the United States Court
of Appeals for the Ninth Circuit.

MEMORANDUM FOR THE RESPONDENT

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MEMORANDUM FOR THE RESPONDENT

OPINIONS BELOW

The opinion of the Tax Court (R. 19-50), and the dissenting opinion (R. 50-55), are reported at 15 T.C. 800. The opinion of the Court of Appeals (R. 132-137) is reported at 197 F. 2d 56.

JURISDICTION

The judgment of the Court of Appeals (R. 138) was entered on May 29, 1952. The petition for a writ of certiorari was filed on August 25, 1951. By order of Mr. Justice Burton dated September 16, 1952, the time for filing the Commissioner's response to the petition for a writ of certiorari was extended to November 26, 1952. The jurisdiction of this Court is invoked under 28 U.S.C., Section 1254.

DISCUSSION

This case involves the question whether, on the sale of an orange grove, consisting of land, trees and an unmaturing crop of oranges, the gain should be apportioned between ordinary income and capital gain. The court below affirmed the decision of the Tax Court which held that, to the extent that the taxpayers' profit for the year 1944 was attributable to the value of the growing crop, the gain should be taxed as ordinary income. Its decision is in conflict with the decisions of the Court of Appeals for the Fifth Circuit in *Owen v. Commissioner*, 192 F. 2d 1006, and of the Court of Appeals for the Tenth Circuit in *McCoy v. Commissioner*, 192 F. 2d 486.

While this problem will not arise for taxable years beginning with 1951 because of the addition to the Internal Revenue Code of Sections 24(f) and 117(j)(3) by Section 323 of the Revenue Act of 1951, c. 521, 65 Stat. 452, the Bureau of In-

ternal Revenue has informed us that the problem is involved in forty-five pending cases with total tax liabilities in excess of \$1,300,000. We are also informed that the same problem, as it bears upon the tax liability of a purchaser of such property, is involved in ten cases with total tax liabilities in excess of \$1,000,000..

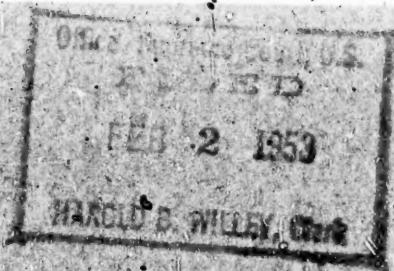
For these reasons the granting of the petition for a writ of certiorari is not opposed.

Respectfully submitted,

ROBERT L. STERN,
Acting Solicitor General.

NOVEMBER, 1952.

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No. 290

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ON WRIT OF CERTIORARI TO THE UNITED STATES
COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE RESPONDENT

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The opinion of the Tax Court (R. 19-50) and the dissenting opinion (R. 50-55) are reported at 15 T. C. 800. The opinion of the Court of Appeals (R. 130-134) is reported at 197 F. 2d 56.

JURISDICTION

The opinion of the Court of Appeals was entered on May 29, 1952: (R. 134.) The petition for a writ of certiorari was filed on August 25, 1952, and was granted on December 8, 1952. (R. 135.) The jurisdiction of this Court is conferred by 28 U. S. C., Section 1254.

QUESTION PRESENTED

The taxpayer was in the business of growing and selling citrus fruits. During the taxable year she sold her interest in a grove on which there was a large crop of oranges which had not reached full maturity. A large portion of the purchase price was attributable to the value of the existing orange crop.

The question is whether, to the extent that the taxpayer's profit is attributable to the existing crop, the gain is taxable as ordinary income, as the Court of Appeals and the Tax Court held, or whether it is taxable as capital gain, as the taxpayer contends.

STATUTE INVOLVED

The applicable provisions of the statute involved are set forth in the Appendix, *infra*, pp. 47-49.

STATEMENT

The facts, as found by the Tax Court, may be summarized as follows:

In 1944, the taxpayer and her two brothers each owned an undivided one-third interest in a 115-acre tract of land (known as the Dofflemyer ranch) consisting of a 110-acre navel orange grove and a 5-acre peach orchard situated near Exeter, Tulare County, California, together with the improvements and equipment. From and after January 1, 1942, the taxpayer and her brothers had operated the ranch under a partnership agreement. (R. 20-21.)

3

In May or June, 1944, the taxpayer and her brothers listed with H. C. Balaam, a local real estate agent, the Dofflemyer ranch and an 80-acre vineyard with a packing-house on it for sale at a lump sum price of \$329,100. After attempting to sell the properties, Balaam obtained an offer of \$132,000 for the vineyard property. Thereupon, the taxpayer and her brothers withdrew the vineyard from sale and agreed that the asking price for the ranch should be \$197,100, or the difference between the asking price for all the properties and the amount of the offer for the vineyard property. (R. 21.)

In his efforts to sell the ranch, Balaam, in June, 1944, contacted J. W. C. Pogue; Pogue had lived in the Exeter vicinity all of his life. He had been the owner of citrus fruit property, and had been in the citrus fruit business since 1907. Since the middle 1920's he had owned property adjacent to the ranch. Before reaching a decision on the matter, Pogue desired to wait in order to determine as accurately as possible what the orange crop would be, and also wanted to have the taxpayer and her brothers bear as much of the production costs of the crop as possible. (R. 21.)

Pogue examined the production records of the Dofflemyer ranch for the preceding year broken down into the various sizes of oranges and the quantity of culls. He went over the property at different times with men from his organization for the purpose of estimating what the orange crop

would be. After having estimated a crop of possibly 80,000 loose boxes of oranges and discounting that amount to 70,000 boxes to be safe, and after considering orange market conditions current in 1944, and estimating that the proceeds from the Dofflemyer orange crop would net about \$120,000 after providing for further cultivation costs, picking, etc., Pogue, during the first part of August, decided to buy the ranch at the asking price of \$197,100. On August 10, 1944, Louis L. Dofflemyer, who personally had been supervising the ranch since 1913, and was thoroughly familiar with it, estimated that the crop of oranges on the trees would produce 70,000 loose boxes. On the same day, August 10, 1944, an agreement was entered into between the taxpayer, her brothers, and Pogue, whereby Pogue agreed to buy the ranch for \$197,100, \$10,000 cash being paid at that time and \$187,100 being payable on or before September 1, 1944. The sellers were to pay all operating costs to September 1, 1944, and taxes and insurance were to be prorated to that date. The proceeds from the peach crop on part of the ranch which was then being harvested went to Pogue who was to bear all expense of harvesting. The growing crop of oranges on the trees also went to Pogue with the land. On or about September 1, 1944, Pogue completed payment for the ranch. The principal reason that Pogue purchased the ranch for \$197,100 was that he estimated he would realize the net amount of \$120,000 from the sale

of the orange crop, and then would be able to sell the ranch for more than the difference between the purchase price and the proceeds from the sale of the crop. He considered that the selling price of \$197,100 for the ranch with the equipment and the growing crop of oranges was below the market value of the properties. (R. 21-23.)

When navel oranges bloom in the spring, the small fruit forms on the trees. During May and June, particularly during the latter month, a considerable portion of the small fruit thus formed drops from the trees. After that has occurred, usually around July 1 in the Exeter area, the orange crop is said to become "set." Navel oranges in the Exeter area generally mature and are ready for picking early in November. From the time the crop is "set" until it is picked and marketed, navel oranges are subject to various types of scale and pests, which, if not controlled, may damage the fruit and render it unmarketable. However, losses from scale and pests on groves which are operated by experienced growers and which receive ordinary care do not present any substantial problem commercially. The Dofflemyer ranch losses from such sources for 1943 amounted to approximately two percent of the total crop. Under normal conditions a grove which has generally produced large-sized fruit will produce that type of fruit each year. After the first of September there is little

that is likely to happen to the quality of the fruit. It is possible for one experienced in orange-growing and familiar with a given grove to estimate with a reasonable degree of certainty during August and September what the production of the grove for the year will be. (R. 26-27.)

The most damaging element to an orange crop in the Exeter area is frost. Generally, the frost period extends from about December 10 to January 15 or 20. In a normal year there are usually a few nights when it is necessary to take some means of protection against frost. Prior to completion of the installation of wind machines on the Dofflemyer ranch in 1939, frosts were severe enough on an average of once in every four years to cause damage to the orange crop. Thereafter, and until the sale of the ranch in 1944, the wind machines provided protection from the frost that occurred and no frost damage was sustained. On an average, severe frosts or freezes occur about once in ten years and some damage can be expected despite the use of protective devices in the grove. However, the wind machines and smudge pots on the Dofflemyer ranch were sufficient to provide adequate protection against frost damage except in periods of record-breaking low temperatures of long duration. Usually, a large part of the navel orange crop is picked before a damaging frost is normally expected. Under the prorate system, which was in effect in 1944, and

under which an orange grove owner picks only an allotted quantity of oranges each week, the period for picking a crop lasts from eight to ten weeks so that some of the matured fruit is exposed to frost risks for a longer time. However, matured oranges are less susceptible to frost damage than unmatured oranges. During the frost period of 1944-1945, there was not enough frost to do any damage to the navel orange crop. During the 1948-1949 period, the Exeter area experienced the worst freeze in the history of the weather bureau for northern California. That season, Pogue did not pick 25 acres of oranges on the Dofflemyer ranch because of damage from freezing. The last previous freeze occurred in 1937. A factor influencing W. Tood Dofflemyer to sell the ranch was the possibility of a freeze during the 1944-1945 season, which would render some portion of the then growing orange crop valueless. While there are risks or hazards in the growing of navel oranges, they are no greater in that industry than they are in many other agricultural or fruit-growing operations. (R. 27-28.)

The cost of cultivation in 1944 of the orange crop to September 1 was \$16,020.54, and was taken as an expense deduction by the operating partnership in its return of income for 1944. (R. 29.)

During the years 1943 and 1944, the market for oranges was at a very high level, with ceiling

prices being in effect for the oranges produced in those years. Growers could expect to receive the ceiling price, plus premiums under certain conditions for first-grade fruit, the ceiling price for the balance of their first-grade fruit and some second-grade fruit, and an over-all average of near ceiling price for all marketable fruit. The average selling price of the oranges produced on the Dofflemyer ranch in 1943 was \$1.71 per loose box, picking and hauling costs were 23 cents per box, thus indicating a value on the tree at maturity of \$1.48 per box. (R. 29.)

Before the prorate system of picking and marketing oranges became effective, cash buyers of unmaturred and matured orange crops on the trees operated more extensively than they have since. It was not uncommon in the Exeter area, before the beginning of the prorate system, for purchases of unmaturred orange crops on the trees to be made during September, and in at least one instance, a purchase was made as early as July. Because of the large profits which cash buyers expect to realize from their purchases, owners who sell to them do not realize as much from their crops as if they held them and sold through consignment organizations. More than 95 percent of the orange crops in the Exeter area are marketed through such organizations. (R. 29-30.)

On or about September 1, 1944, Pogue had estimates or appraisals made of the Dofflemyer

property by three persons familiar with orange grove values in the Exeter area. On the basis of these and an appraisal made by himself, he allocated on his books \$120,000 of the purchase price of the ranch to the navel orange crop on the trees, \$23,000 to the 115 acres of land, \$38,600 to the 110 acres of orange trees, \$1,000 to the five acres of peach trees, \$6,000 to the wind machines, \$3,000 to the pumping plants, and \$3,000 to the trucks, tractors, etc., on the property. (R. 30.)

Beginning in November, 1944, the orange crop on the Dofflemyer ranch was harvested, and produced 74,268 loose boxes from which Pogue received gross proceeds of \$146,000. Cultivation costs from September 1 to maturity, plus picking and hauling costs, amounted to approximately \$20,000, thus resulting in a net return of about \$126,000 from the sale of the crop. (R. 30.)

In her joint income tax return the taxpayer reported the sale of her one-third interest in the Dofflemyer ranch on September 1, 1944, at a net gain of \$48,819.82, fifty percent of which, or \$24,409.91, was included in taxable income as a long-term capital gain. No portion of the taxpayer's one-third share of the selling price of the ranch was allocated to the growing oranges on the trees at the time of the sale. The Commissioner determined that of the reported net gain of \$48,819.82 from the sale, \$40,833.33 represented the taxpayer's one-third share of the fair market

value of the growing crop of oranges on the trees, and that said amount constituted ordinary income and not capital gain. (R. 30-31.)

The Tax Court found that \$40,000 of the total price received was allocable to the growing crop on the trees. (R. 31.) It held that the taxpayer's portion of this was taxable as ordinary income. (R. 31-50.) Two judges dissented. (R. 50-55.) The decision of the Tax Court was affirmed by the Court of Appeals. (R. 130-134:)

SUMMARY OF ARGUMENT

The taxpayer was in the business of growing and selling oranges. During the taxable year, she sold her interest in a citrus grove after the time when the current orange crop had become "set", but prior to the time when the fruit would reach full maturity. More than 20 percent of the purchase price paid for the entire property was attributable to the value of the growing crop of fruit which was then on the trees. The Court of Appeals and the Tax Court correctly held that the portion of the profit which was derived on account of the existence of the growing fruit was taxable as ordinary income, rather than at capital gain rates as contended by the taxpayer.

The growing fruit, as the taxpayer admits, does not come within the definition of a capital asset. Furthermore, an existing crop does not qualify as property used in the trade or business and is not entitled to capital gain treatment under Section

117 (j) of the Internal Revenue Code. The growing fruit, as the Tax Court found, was being held by the taxpayer primarily for sale to customers in the ordinary course of her trade or business, and Section 117 (j) (1) expressly excludes such property from the benefits of capital gain treatment.

Crops grown by farmers have long been considered for tax purposes as being different from the land on which they are grown. They constitute the source of the ordinary business income earned by farmers. Consequently, when Congress extended capital gain treatment in Code Section 117 (j) to sales or exchanges of property used in a trade or business and excepted from that section property which is inventorial or which is held for sale to customers, it drew a distinction between property, like machinery and plant, which is employed in a business, and property which is normally sold to produce ordinary business income. The land and the fruit-bearing trees owned by the taxpayer come within the former class of property, but the existing crop comes within the latter. The statute did not contemplate that gain from the sale of a farmer's crops, whether sold before or after maturity and whether sold to one or more purchasers, should be taxed at preferential capital gain rates.

The taxing statute employs its own standard of what assets should be considered as capital assets or should be taxed at capital gain rates. It is, accordingly, quite immaterial whether Cali-

California law would regard the sale of a citrus grove with a growing crop of fruit as being an indivisible sale of real property. In the present case, the sale of the citrus grove involved divisible elements under the taxing statute; the considerable portion of the profit which was realized by the taxpayer and which the Tax Court found was attributable to the existing crop of oranges, must be taxed as ordinary income.

The meaning of Code Section 117 (j), as it existed during the taxable year and as applicable to the present case, is emphasized by subsequent Congressional amendments which, for future years, expressly provided that the benefits of Section 117 (j) should be extended to a sale of farmland with an unharvested crop. Indeed, in extending these benefits for future years, Congress did so only by removing from such taxpayers the right, which they previously enjoyed, of deducting the expenses of the unharvested crop from their ordinary income.

There is an alternative reason for sustaining the decision of the Court of Appeals. Even if the growing crop could be classified as property used in the taxpayer's trade or business under Code Section 117 (j), the benefits of that section would not be available to the taxpayer since it is operative only with respect to property which is used in a trade or business and which has been held by a taxpayer for more than 6 months. Since, as the Court of Appeals ruled, the existing crop

of oranges had not been held by the taxpayer for 6 months at the time when the property was sold, she is not entitled to capital gain treatment on the portion of the profit which was attributable to the existing crop.

ARGUMENT

I

THE SALE OF A CITRUS GROVE, TOGETHER WITH A GROWING CROP OF FRUIT, RESULTS IN THE REALIZATION OF ORDINARY INCOME TO THE EXTENT THAT PROFIT IS ALLOCABLE TO THE VALUE OF THE GROWING FRUIT

A. Introductory.—The single issue for decision in this case is whether, on the sale of an orange grove by one whose business is that of growing and selling oranges, the profit attributable to the growing crop of fruit is taxable as ordinary income rather than at capital gain rates.¹ The Tax Court and the Court of Appeals were correct, we believe, in deciding that the profit must be classified as ordinary income under the taxing statute. While a contrary result was reached in *Owen v. Commissioner*, 192 F. 2d 1006 (C. A. 5th), and in *McCoy v. Commissioner*, 192 F. 2d 486 (C. A. 10th), the Government respectfully submits that those cases were erroneously decided.

¹ During the taxable year in controversy, gains from the sale of capital assets, held for more than 6 months, were taxed at a preferential rate which would not exceed 25 percent of the gain. Section 117 (b) and (c) (2), Internal Revenue Code, as amended by Section 150 (c) of the Revenue Act of 1942, c. 619, 56 Stat. 798.

Since the proper answer to the question depends upon the meaning of terms employed in the statute, we start with the definition of "capital assets" in Code Section 117 (a) (1) (Appendix, *infra*, p. 47). That section defines capital assets to include all property held by a taxpayer, and then excludes from the definition (1) stock in trade or inventorial property; (2) property held primarily for sale to customers in the ordinary course of the taxpayer's trade or business; (3) property used in the trade or business which is subject to deductions for depreciation; (4) certain non-interest bearing, governmental obligations issued on a discount basis; and (5) real property used in the taxpayer's trade or business.

It is readily apparent that none of the property elements which were transferred when the taxpayer sold her interest² in the orange grove comes within the statutory definition of a capital asset. The land itself falls within the exclusion of real estate used in the trade or business. The fruit-bearing trees, being depreciable in nature, come within the exclusion of depreciable property used

² The taxpayers are husband and wife who filed a joint return. Since the interest in the property was owned by the wife, she will be referred to as the taxpayer.

The taxpayer owned a one-third interest in the property, and the case involves the proper tax on her share of the profit realized. However, for purposes of simplicity, the issue will be dealt with as though she were the sole owner of the property.

in the trade or business. Both the land and the trees, because they are property used in the trade or business, are entitled to the benefits of capital gain treatment under the provisions of Code Section 117 (j) (Appendix, *infra*, pp. 47-49), discussed at pages 19-22, *infra*. The growing fruit is excluded from the definition of a capital asset, we contend, because it was being held primarily for sale to customers in the ordinary course of the taxpayer's trade or business, and, for the same reason, it does not qualify for capital gain treatment under Section 117 (j), since that section, like Section 117 (a) (1), excludes property which is being held for that purpose.

The taxpayer does not contend that the definition of "capital assets" in Section 117 (a) (1) is applicable. Her claim to preferential capital gain treatment on the profit derived from the sale of the growing fruit is based on the provisions of Code Section 117 (j) (2) which considers the gains (to the extent that they exceed losses) from sales or exchanges of "property used in the trade or business," and held for more than 6 months, as gains from the sale or exchange of capital assets held for more than 6 months. For the purpose of that subsection, Section 117 (j) (1) defines "property used in the trade or business"

³ To the extent that gains from the sale or exchange of such property exceed losses, the excess is taxable at the preferential rate of 25 percent applicable to long-term gains from the sale or exchange of capital assets. See fn. 1, *supra*, p. 13.

to include depreciable property used in the trade or business which has been held for more than 6 months, and real property used in the trade or business which has been held for more than 6 months, but excludes property which is inventorial or which is held primarily for sale to customers in the ordinary course of the taxpayer's trade or business. The taxpayer asserts that the growing fruit must be regarded as "real property" because its character is inseparable from that of the trees and because, as it is further contended, the fruit is regarded as real property by California law; for that reason, the taxpayer claims that Section 117 (j) (2) is applicable to extend capital gain treatment not only to the profit attributable to the sale of the land and the trees, but also to the portion of the profit realized on account of the existing crop of fruit which the purchaser acquired on the sale.

The short answer to the taxpayer's ultimate contention, as given by both of the courts below, is that the growing crop, whether it be regarded as real property or as personal property, does not fit the Section 117 (j) (1) definition of "property used in the trade or business" for the reason that, to the taxpayer, whose normal business activity consisted of growing and selling oranges, the existing crop was "property held by the taxpayer primarily for sale to customers in the ordinary course of [her] * * * trade or business." Further, as the Court of Appeals

ruled, the fact that the existing crop had not been held for more than six months was an additional reason why the gain was not taxable at preferential rates under the provisions of Section 117 (j).

B. Section 117 (j), Internal Revenue Code, Did Not Extend Capital Gain Treatment to Growing Crops Sold Prior to 1951. A Farm Crop Is Not Property Used in the Trade or Business.—

The legislative history of the capital gains provisions and of Section 117 (j), which extended capital gain treatment to certain property used in the trade or business, demonstrates the error of the taxpayer's contention that Congress intended to tax as capital gain the profit derived from a growing crop of fruit in the circumstances of this case. Such preferential taxation was not permitted by the statute prior to the express amendment of Section 117 (j) made by Section 323 of the Revenue Act of 1951, c. 521, 65 Stat. 452, which is in terms applicable only to taxable years beginning with 1951 and which is discussed, *infra*, pp. 38-42.

Special provisions respecting the taxation of gains and losses from capital assets first appeared in Section 206 of the Revenue Act of 1921, c. 136, 42 Stat. 227. *Burnet v. Harmel*, 287 U. S. 103, 105-106; H. Rep. No. 350, 67th Cong., 1st Sess., pp. 10-11 (1939-1 Cum. Bull. (Part 2) 168, 176); S. Rep. No. 275, 67th Cong., 1st Sess., pp. 12-13 (1939-1 Cum. Bull. (Part 2) 181,

189-190). While, during the course of years, there have been important changes in the tax treatment of capital gains and losses, and in the precise definition of what constitutes a capital asset, the general approach has been one of according favorable tax treatment to increments in value accruing to property held as an investment or for non-business purposes, as distinguished from gains which result from a taxpayer's ordinary business activity. *Rollingwood Corp. v. Commissioner*, 190 F. 2d 263, 266-267 (C. A. 9th). See Miller, *The "Capital Asset" Concept: A Critique of Capital Gains Taxation*, 59 Yale L. J. 837 (Part I), and 1057 (Part II) (1950).

One of the important changes in definition was made by Section 117 (a) (1) of the Revenue Act of 1938, c. 289, 52 Stat. 447, which excluded from the term "capital assets" property used in a trade or business which was of a character which would be subject to the allowance for depreciation. The change was stated to be in recognition of "the principle that gains or losses realized upon the sale, exchange, or other disposition of such property are business gains or losses * * *." H. Rep. No. 1860, 75th Cong., 3d Sess., pp. 7, 34-35 (1939-1 Cum. Bull. (Part 2) 728, 732-733, 752-753).

As a consequence of the 1938 change in definition, where a taxpayer owned real property on which depreciable improvements were erected, and such property was used in a trade or busi-

ness, the land was classified as a capital asset, but the improvements, being depreciable, were not. Gain or loss on the sale of such property was required to be apportioned between the land and the improvements.

This is the background of the addition of Code Section 117 (j) made by Section 151 (b) of the Revenue Act of 1942, c. 619, 56 Stat. 798. As reported to and passed by the House of Representatives, the 1942 Revenue Bill would have added "buildings and similar real property improvements" used in the trade or business to the definition of capital assets in Section 117 (a) (1) and would have also extended capital gain treatment (to the extent that gains exceeded losses) to all other depreciable property used in a trade or business. H. Rep. No. 2333, 77th Cong., 2d Sess., pp. 52-53, 53-54 (1942-2 Cum. Bull. 372, 414, 415).¹

¹ In explaining the proposed amendment, the House Ways and Means Committee stated (H. Rep. No. 2333, *supra*, pp. 52-53, 53-54 (1942-2 Cum. Bull. 372, 414, 415)) :

"Your committee has revised the definition of capital assets, so that buildings and similar real estate improvements are included within the definition. Under the present law, buildings and similar real estate improvements are not treated as capital assets, because they are subject to depreciation allowances. The present law not only results in unfairness to the taxpayer but also in considerable administrative difficulty. For example, if an apartment house in [is] sold, under the present law, it is necessary to separate the land from the building for income-tax purposes. This is because the gain allocable to the building is subject to the normal and surtax rates, while the gain allocable to the land is subject to the capital gain rate. On the other hand, if the taxpayer suffers a loss on the building, such loss is treated as an ordi-

The Senate version, which was that ultimately adopted, was to remove real property used in a trade or business from the definition of a capital asset under Code Section 117 (a) (1) but to add Code Section 117 (j) so as to extend capital gain treatment (to the extent that gains exceed losses)

ordinary loss and deductible in full from ordinary income, whereas if he suffers a loss on the land, that is treated as a capital loss and subject to the capital loss limitations. It is very difficult to allocate the capital gain or loss between the land and the buildings. Accordingly, your committee has changed the rule of existing law, so that both the land and the building, or similar real estate improvements, are treated as capital assets.

* * * * *

"Under existing law, the gain or loss from the sale or exchange of depreciable property is not treated as a capital gain or capital loss, but as an ordinary gain or an ordinary loss. This rule was originally inserted as a relief provision to enable corporations to have the full benefit of a loss from the sale of machinery, instead of being limited by the capital loss provisions, which would permit it only a certain percentage of the loss. It was felt at that time that the taxpayer should not be denied the full loss because it sold the property at a loss instead of abandoning the property. While this rule provided relief in case a loss was realized, it appears that many taxpayers are able to dispose of their depreciable property at a gain over its depreciated cost. To treat such a gain as an ordinary gain will result in an undue hardship to the taxpayer. For example, a taxpayer sells certain trawlers used in his business to the Government. If the gain from the sale is regarded as an ordinary gain, it may result in the taxpayer receiving practically nothing for his property. Another example is where the proceeds of insurance on destroyed property exceed the cost of the property. The existing law treats such gain as ordinary income. The gain or loss resulting from the involuntary conversion of property into other property or money is also treated as an ordinary gain or loss. The theft of an article, which is

to all depreciable and real property used in the trade or business which was held for more than six months and which was not inventoried or was not being held primarily for sale to customers in the ordinary course of the taxpayer's trade or business. S. Rep. No. 1631, 77th Cong., 2d Sess., pp. 50, 119, 120 (1942-2 Cum. Bull. 504, 545, 594). Losses from the sale or exchange of such

insured, is an example in point. Your committee has provided the following solution for this problem:

"(a) If the total gains in such cases exceed the losses, such gains shall be considered as gains from the sale or exchange of capital assets held for more than 15 months. Buildings and similar real property improvements are not included in this provision, unless gains or losses therefrom result from an involuntary conversion. This is because buildings and similar real property are treated under a different provision of the bill. In determining whether the gains exceed the losses, 100 percent of such gains or losses are taken into account. In the case of involuntary conversions, the existing law is amended to provide that the loss shall be recognized upon the conversion.

"(b) If the gains do not exceed the losses in such cases, such gains and losses will be treated as ordinary gains and ordinary losses instead of capital gains or capital losses. Where the losses exceed the gains, the excess loss will be deductible from income as an ordinary loss."

The Senate Finance Committee agreed that it was desirable for land and improvements to have the same character, but considered also that all property used in the trade or business should be treated alike and that no distinction should be made between the land and its improvements and other property used in the trade or business. It stated (S. Rep. No. 1631, *supra*, p. 50 (1942-2 Cum. Bull. 504, 545)):

"(2) Under the House bill losses from the sale of real property and buildings were treated as capital losses, even though the property was used in the trade or business. Your committee has changed this rule by taking buildings and real

assets, however, were not made subject to the limitations applicable to capital losses.

In determining the applicability of Section 117 (j) to the circumstances of this case, it is important to emphasize that Congress, while granting

estate used in the trade or business of the taxpayer out of the definition of capital assets, and applying to them the same rule which the House bill applies to gains and losses from involuntary conversions from the sale or exchange of certain depreciable property. If the total gains exceed the losses, such gains will be considered as gains from the sale or exchange of capital assets held for more than six months. If the gains do not exceed the losses, such losses will be treated as ordinary gains and ordinary losses instead of capital gains and capital losses.

"It is believed that this Senate amendment will be of material benefit to businesses which, due to depressed conditions, have been compelled to dispose of their plant or equipment at a loss.

"The bill defines property used in a trade or business as property used in the trade or business of a character which is subject to the allowance for depreciation, and real property held for more than 6 months which is not properly includible in the inventory of the taxpayer if on hand at the close of the taxable year or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business. If a newspaper purchased the plant and equipment of a rival newspaper and later sold such plant and equipment at a loss, such plant and equipment, being subject to depreciation, would constitute property used in the trade or business within the meaning of this section."

It also said (S. Rep. No. 1631, *supra*, p. 119 (1942-2 Cum. Bull. 504, 594)):

"Subsection (a) of this section, in the House bill, included real property improvements, used in the trade or business and subject to an allowance for depreciation, within the definition of "capital assets" in section 117 (a), so that such improvements would have the same character for tax pur-

capital gain treatment to sales or exchanges of property used in a trade or business, like plant or equipment (see fn. 5, *supra*, p. 22), carefully excepted from this classification property which was inventorial or which was held primarily for sale to customers in the ordinary course of the taxpayer's trade or business. The same differentiation had already existed in Section 117 (a) (1), which excludes from the definition of a capital asset property which is inventorial or which is held primarily for sale to customers. In other words, Congress continued to withhold capital gain treatment with respect to a taxpayer's stock in trade since such property, in contrast with that which is *used* in a trade or business, is *sold* in the ordinary conduct of the business and the sale proceeds are the normal source of ordinary business profits. Cf. *Fields v. Commissioner*,

9 as the land on which they stand. While your committee believes it desirable for the land and the improvements to have the same character, it considers it more appropriate to treat all property used in the trade or business alike, and not to distinguish between land and other property used in the trade or business. Accordingly, this subsection has been changed to provide that land used in the trade or business is not within the definition of "capital assets" in section 117 (a), and will therefore have the same character as improvements subject to an allowance for depreciation, which under existing law are excepted from that definition. In accordance with this policy, changes have also been made in subsection (b) of this section, relating to the treatment of gains and losses on the sale, exchange, and involuntary conversion of depreciable property, to subject to such treatment land used in the trade or business."

189 F. 2d 950 (C. A. 2d); *Rollingwood Corp. v. Commissioner*, 190 F. 2d 263 (C. A. 9th).⁶

There is nothing in the statutory language of Section 117 (a) (1) and (j), or in the legislative purpose of granting special tax consideration to capital assets and to property used in a trade or business, which even tends to support the taxpayer's argument that a growing farm crop was intended to be accorded this special tax preference. On the contrary, where crops are grown for sale, they are, as the Tax Court said (R. 46), the farmer's "stock in trade" and consequently are, in the statutory scheme, the opposite of capital assets and of property *used* in a trade or business.

The courts below, we believe, correctly applied the provisions of Section 117 (j). The taxpayer-

⁶ The exclusion from the definition of capital assets of "property held by the taxpayer primarily for sale in the course of his trade or business" was added by Section 208 (a) (8) of the Revenue Act of 1924, c. 234, 43 Stat. 253. The language was added (H. Rep. No. 179, 68th Cong., 1st Sess., p. 19 (1939-1 Cum. Bull. (Part 2) 241, 255))—

"to remove any doubt as to whether property which is held primarily for resale constitutes a capital asset, whether or not it is the type of property which under good accounting practice would be included in the inventory."

The words "to customers" in the "ordinary" course of his trade or business were added by Section 117 (b) of the Revenue Act of 1934, c. 277, 48 Stat. 680, and were explained as (H. Conference Rep. No. 1385, 73d Cong., 2d Sess., p. 22 (1939-1 Cum. Bull. (Part 2) 627, 632))—"making it impossible to contend that a stock speculator trading on his own account is not subject to the provisions of section 117." See *Gruver v. Commissioner*, 142 F. 2d 363, 368 (C. A. 4th).

er's land and grove trees, being the property used to produce the crop and not being held primarily for sale to customers, clearly constituted the property used in the taxpayer's trade or business; the land and trees, consequently, were entitled to the benefits of Section 117 (j). The existing crop of fruit, however, was not property used in the trade or business, for each annual crop was destined to be sold to customers in the ordinary course of the taxpayer's business and was the normal source of the business income which has always been taxed at ordinary income tax rates.

The fact that all the crop was sold to a single customer who acquired it along with the grove property does not alter the character of the gain realized by the taxpayer which was attributable to the growing fruit. Thus, in *Williams v. McGowan*, 152 F. 2d 570 (C. A. 2d), where the taxpayer sold his entire business and business property, it was held that each item of property embraced in the sale must be measured against the statutory standard. And, significantly, the stock in trade in *Williams v. McGowan*, though sold to the single purchaser of the business rather than to customers in the normal conduct of the business, was held to have resulted in ordinary income. See also *Grace Bros. v. Commissioner*, 173 F. 2d 170, 178 (C. A. 9th).

The taxpayer's argument that she was not in the business of selling immature fruit to customers does not really meet the test of the statute

so as to qualify the profit for capital gain treatment. The statute is not concerned with whether the property is actually sold to customers in the ordinary course of business. It excepts from capital gain treatment property which is "held" by the taxpayer primarily for sale to customers; and, we submit, one who normally sells the crop at maturity, has held it for that purpose from its inception.⁷ The sale of fruit to customers is the ultimate objective of the taxpayer's business, and the fruit could only have been held by the taxpayer for that purpose.

The Tax Court, it will be noted, found as a fact that the crop was being held primarily for sale to customers in the ordinary course of the taxpayer's trade or business. (R. 47.) This conclusion is one which the Courts of Appeals have generally accepted as being primarily within the province of the fact finders. *Friend v. Commissioner*, 198 F. 2d 285, 287 (C. A. 10th); *King v. Commissioner*, 189 F. 2d 122, 124 (C. A. 5th), certiorari denied, 342 U. S. 829; *Harriss v. Commissioner*, 143 F. 2d 279, 281 (C. A. 2d); *Rubino v. Commissioner*, 186 F. 2d 304 (C. A. 9th), certiorari denied, 342 U. S. 814.

Moreover, no matter what the purpose for which the crop was held, the taxpayer cannot bring herself within the definition of Section 117 (j)(1) as an initial matter unless the crop was

⁷ See Miller, *The "Capital Asset" Concept: A Critique of Capital Gains Taxation*, 59 Yale L. J. 1057, 1083 (1950).

"used" in the trade or business and this, we submit, is a conclusion which would be altogether out of harmony with the concepts employed by Congress. The growing crop is not like the plant or equipment which Congress thought of as being used in a trade or business. See fn. 5, *supra*, p. 22.⁸ The farmer's crop is no more "used" in the farming business than the products of a manufacturer are "used" in the manufacturing business. In the final analysis, the taxpayer was in the business of growing and selling oranges; the gain of \$40,000 which was realized on the transfer of the existing, growing crop represents the very kind of business income which Congress intended to tax as ordinary income.

Crops grown by farmers have always been regarded, so far as federal tax matters are concerned, as a species of property quite different and distinct from the land on which they are grown. As early as 1920, in O. D. 714, 3 Cum. Bull. 49 (1920), it was ruled that where farm land is purchased and a growing crop is in existence, the purchaser, in calculating his profit after the crop has been harvested and sold, may deduct the appropriate part of the price attributable to the value of the growing crop which was acquired

⁸ Treasury Regulations 111, promulgated under the Internal Revenue Code, Section 29.117-7, in describing the operation of Code Section 117 (j) uses the following as examples of property used in a trade or business: (1) machinery; (2) factory premises consisting of land and building; (3) land used as a storage lot for trucks; (4) a boat; (5) warehouse.

as an incidence of the purchase of the land. It was thus recognized that, though there was but a single sale of land together with growing crops, the purchaser had made two distinct investments with separable taxable incidents. His investment in the farm land was of a more permanent nature which would be used in his farming business. That investment could only be recouped on a future disposition of the land itself. However, to the extent that the total purchase price represented the cost of acquiring the growing crop, the purchaser was investing in the very type of property which would be sold in his business of farming, and the Bureau's ruling, recognizing the distinction, permitted that portion of the investment to be recouped in the tax computation at the time when the harvest was sold so as to permit an accurate reflection of his true business income.*

* In the context of the present case, the need to separate the elements involved in the sale is quite apparent. Thus, the orange crop which was in existence when the grove was purchased was ultimately sold by the purchaser for \$146,000 which, after expenses of \$20,000 incurred by him, resulted in a net return of \$126,000. (R. 30.) We believe, contrary to the plain implications that follow from the taxpayer's argument, that the purchaser did not acquire indivisible elements in the sale, but that, to the extent that part of the purchase price represented the value of the growing crop which was distinct from the value of the land and of the fruit-bearing trees, that value (\$40,000) should be deducted from the net return of \$126,000 in determining how much gain he realized in selling the mature crop, so that only \$86,000 would be taxable to him at ordinary income tax rates.

Thus there is a distinction between the fruit-bearing trees and the fruit crop is apparent in other respects. From an early time it was recognized that the fruit trees are depreciable property "used in the trade or business" of one who grows fruit for sale, so that the cost of the trees, together with the capital expenditures required to bring them to a productive state, are recoverable through allowances for depreciation. O. 797, 1 Cum. Bull. 130 (1919); Mim. 6030, 1946-2 Cum. Bull. 45; and Mim. 6030 (Supp. 1), 1948-1 Cum. Bull. 42; Section 29.23 (a)-11, Treasury Regulations 111, promulgated under the Internal Revenue Code, and corresponding provisions of prior Regulations beginning with Article 110, Treasury Regulations 62, promulgated under the Revenue Act of 1921; *Thompson & Folger Co. v. Commissioner*, 17 T. C. 722; *Redlands Security Co. v. Commissioner*, 5 B. T. A. 956. However, distinct from the capital expenditures incurred in connection with the trees are the expenses incurred in connection with the growing of each annual crop of fruit. The latter are deductible from gross income as business expenses because incurred in the farmer's business of growing and selling crops. Code Section 23 (a) (1) (A); Section 29.23 (a)-11, Treasury Regulations 111, *supra*. In this very case, the taxpayer and her brothers had deducted more than \$16,000 of the expenses attributable to the growing of the 1944 crop and bringing it to

partial maturity. (R. 29.) The statute, we submit, never contemplated that the profit derived from the crop should be taxed at preferential capital gain rates, while the crop expenses (to which the taxpayer was concededly entitled) were being deducted from ordinary income.

From a practical viewpoint, moreover, there is a substantial difference between the farmer's crop and the property used to grow it. In that respect, the farming business is analogous to the manufacturing business, the land and trees here being similar to the machinery and equipment which the manufacturer uses to produce his products. These are the items of property which each uses in his trade or business and which Congress intended to cover by Section 117 (j). The growing crop, so far as the farmer is concerned, is similar to goods in process of manufacture, for each is ultimately destined to be sold to customers and to be the source of normal business profit. Such property was expressly excluded by Congress from any special tax considerations. The Tax Court, we believe, correctly summarized this when it observed (R. 45-46):

That farmers, fruit growers, and the like regard, think of and deal with their crops, whether growing or mature, as being something apart from or other than the land itself, is, we think, so generally known and accepted as to require no discussion or amplification here. The crop is their stock

in trade and from the time the fruit appears on the plant, vine, or tree, it is thought of in terms of the units by which it is measured for sale and of the anticipated prices per unit. In short, the primary purpose and objective of the farmer or fruit grower is the sale of his crop to some customer or customers. * * *

The particular facts of the present case emphasize the validity of these observations of the Tax Court. Thus, while the contacts with Pogue, ultimate purchaser, were made in May or June of 1944, he decided (R. 21) "to wait in order to determine as accurately as possible about what the orange crop would be * * *." It was only after he had examined the production records for the preceding year, and had inspected the property at different times to estimate the size of the present crop, and to predict what net proceeds could be realized from its sale, that Pogue decided to buy the property. The sale, which was consummated in August, took place after the crop had become "set." (R. 22.) Indeed, the Tax Court found as a fact that the reason why he was willing to pay the asking price was that (R. 23)—

he estimated he would realize the net amount of \$120,000 from the sale of the orange crop and then would be able to sell the ranch for more than the difference between the purchase price and the proceeds from the sale of the crop. * * *

It is clear that the price paid for the property was affected by the existence of the growing crop. Reviewing all the evidence, the Tax Court concluded (R. 44):

That in the instant case the oranges, exclusive of the land, trees and improvements, did in fact constitute a distinct and important item or element in the lump sale which occurred, is not, in the light of the evidence, now open to question. * * *

If the sale had been earlier, before the crop had become set and before the earlier risks of the grower had passed, the price paid would by no means have been the same. And, we submit, in every such sale, to the extent that the growing crop possesses an ascertainable value, that value enters into the price paid for the entire property. No reasonable purchaser or seller could exclude this from consideration. Even the sellers here were dealing with the crop as something separate from the trees and land, for the Tax Court, summarizing the evidence, found (R. 45):

On the basis of his experience that freeze years occurred in cycles, W. Todd Doffmeyer, who negotiated the sale, felt certain that the season of 1944-1945 would be a freeze year and desired to cash in before cold weather, letting the purchaser run the risk of crop loss due to frost. His testimony, in effect, was that if he had not thought there would be a crop loss due to frost, and had thought they would have

received ceiling price for the oranges, he would not have sold but would have held the property. In other words, all the parties to the sale did, in fact, regard the oranges as a crop of fruit on the trees, and not as trees on land. Pogue was buying oranges which he planned to harvest and sell to customers. Petitioner and her brothers were selling their crop of oranges for cash in hand, allowing to the purchaser the added revenue if they reached maturity without loss and the high prices continued.

The foregoing, quite clearly, refutes the taxpayer's assertion (Br. 17) that "In their dealings the sellers gave no recognition to the artificial severance of immature crop from trees which the Commissioner has proposed." It also refutes the taxpayer's broader assumption that (Br. 24), until such time as it has actually been picked, an existing growing crop cannot be differentiated from the non-existing crops of future years and merely represents an expectation of future income.

A successful citrus crop, as is true of other farm crops, moreover, is largely dependent on expenditures of money and labor in the form of cultivation. With personal efforts playing so large a part in the growing of a successful crop, it is clear that there has been no conversion of a capital asset or of property used in the business when the crop is sold, even though the sale takes place prior to maturity and even though the growing crop is sold together with the producing grove.

The Court of Appeals properly concluded that this was an additional reason why the capital gains benefit was not intended to be applicable to the sale of the growing crop, stating (R. 132):

Since the purpose of capital gains relief is to avoid ordinary income taxation on the realization of values that have accumulated over a long period of time, we are reinforced in our conclusion that the growing crop here is not entitled to the relief of § 117 (j). The value of the crop is largely the product of effort within the tax year and the periodic realization of income from the crop covers a short period approximating the tax year. *Rollingwood Corp. v. C. I. R.*, *supra*.

C. California Law Does Not Determine What Property Is Used In A Trade Or Business Under Code Section 117 (j).—It is pertinent to observe that much of the taxpayer's argument is founded on the erroneous assumption that California law determines whether the growing crop is an inseparable part of the real estate and is to be considered as property used in the trade or business for the purposes of the Section 117 (j) (1) definition. It is well settled, however, that the concepts employed in the taxing statute are to be given a uniform, nation-wide application and that they are not controlled by local law except where Congress has so intended. *Burnet v. Harmel*, 287 U. S. 103, 110; *Founders General Co. v. Hoey*, 300 U. S. 268, 275; *Thomas v. Perkins*, 301

U. S. 655, 659; *Lyeth v. Hoey*, 305 U. S. 188, 194; *United States v. Pelzer*, 312 U. S. 399, 402-403; *Estate of Putnam v. Commissioner*, 324 U. S. 393, 395. Thus, in *Burnet v. Harmel*, *supra*, it was held that the question whether the execution of an oil and gas lease was to be taxed as the sale of a capital asset was not governed by concepts of local law which regarded such a lease as effectuating a sale of the oil and gas in place. Instead, upon examination of the purposes and scope of the capital gains provisions, it was held that the lessor received ordinary income within the meaning of the federal taxing statute.

While the taxpayer constantly assumes the contrary (Br. 12-14), we need only point to the discussion in the Tax Court's opinion (R. 33-41) as illustrating the variety of views among the states on the question whether a growing crop is part of the real estate—a question which, as the Tax Court aptly observed (R. 41), cannot be answered categorically, even in a single jurisdiction, without reference to the context of the particular type of legal problem presented. It is for this reason that the answer to the question here must be found in the meaning of the terms used in the taxing statute.

Furthermore, what local law may regard as inseparable property elements may, from the viewpoint of the taxing statute, involve separable elements giving rise to separate tax consequences. Thus, in *West v. Commissioner*, 150 F. 2d 723

(C. A. 5th), certiorari denied, 326 U. S. 795, a conveyance of land together with an interest in the underlying minerals was held taxable as the sale of a capital asset only so far as the surface land was concerned, but to have resulted in the realization of ordinary income to the extent that it involved the granting of rights in the underlying minerals. Again, as we have already observed (p. 18, *supra*), from 1938 through 1941, property of a depreciable nature used in a trade or business was excluded from the capital asset definition, so that where a taxpayer possessed real estate which was used in the trade or business on which depreciable improvements existed, a sale of the entire property was a conversion of a capital asset only so far as the non-depreciable land was concerned, and the depreciable improvements were treated as ordinary assets. *Fackler v. Commissioner*, 133 F. 2d 509, 511 (C. A. 6th); Section 117 (a) (1) of the Revenue Act of 1938, c. 289, 52 Stat. 447, and of the Internal Revenue Code; Article 117-1, Treasury Regulations 101, promulgated under the Revenue Act of 1938, and Section 19.117-1, Treasury Regulations 103, promulgated under the Internal Revenue Code; I. T. 3217, 1938-2 Cum. Bull. 94; I. T. 3246, 1939-1 Cum. Bull. (Part 1) 137. Indeed, if the taxpayer had sold the grove property during the period 1938-1941, the gain attributable to the fruit-bearing trees, which are depreciable prop-

erty, would have been taxed as ordinary income and capital gain would have been limited to the profit realized from the transfer of the land itself. This result, quite clearly, would have followed under the statute as it then existed, regardless of whether California law would have viewed the sale as indivisible.

There is nothing in Section 117 (j) or in its legislative history to indicate that Congress, departing from concepts long employed in the definition of a capital asset, intended to make local rules of law the guiding standard for ascertaining whether particular property is used in a trade or business or whether divisible property elements are involved in a particular transfer. Accordingly, whether California law would classify the growing fruit as an inseparable element of the real estate, is altogether irrelevant to the federal tax question involved in this case. Furthermore, it is not material whether the growing crop is classified as personal or real property under the taxing statute for, as both of the courts below observed (R. 43-44, 131-132), whether regarded as personal or real property, the growing crop is not entitled to the benefits of Section 117 (j) since it was being held primarily for sale to customers, and the exclusion of such property from the definition in Section 117 (j). (1) is equally applicable to both real and personal property.

D. The Inapplicability of Code Section 117 (j) to Growing Crops Is Confirmed by Subsequent Congressional Action.—Cumulative support, if more were needed, for the correctness of the decisions below will be found in Section 323 of the Revenue Act of 1951, c. 521, 65 Stat. 452. Section 323 (a) (1) of that Act added to the definition of "property used in the trade or business" in Section 117 (j) (1), so that that section now provides that "Such term also includes * * * unharvested crops to which paragraph (3) is applicable." Section 323 (a) (2) added paragraph (3) to Code Section 117 (j) to provide that where there is an unharvested crop on land which is used in the trade or business and held for more than 6 months, if the crop and the land are sold at the same time and to the same person, "the crop shall be considered as 'property used in the trade or business.'" By Section 323 (c), these amendments were made effective only with respect to sales or exchanges occurring in taxable years after December 31, 1950. Section 323 (b) (1) of the 1951 Act also added Section 24 (f) to the Code, to provide that where an unharvested crop is considered as property having the benefits of Code Section 117 (j), no deduction should be allowed in computing net income (whether or not in the year of the sale) with respect to any expenses attributable to the production of the crop. Section 323 (b) (2) amended Code Section

113 (b) (1) so that the deductions disallowed under Code Section 24 (f) would be added to the basis of the property.¹⁰

Several significant conclusions are evident from these statutory changes. First, the Committee did *not* state that the amendment was declaratory of existing law, and that the Bureau of Internal

¹⁰ In explaining these amendments to the Code, the Senate Committee on Finance stated (S. Rep. No. 781, 82d Cong., 1st Sess., pp. 47-48 (1951-2 Cum. Bull. 458, 491-492)) :

"Section 117 (j) of the code provides, in effect, that a net gain from sales of properties 'used in the trade or business' of the taxpayer, including 'real property' so used, if held more than 6 months is to be treated as a capital gain. In the case of a net loss, it is treated as an ordinary loss. Where unharvested crops are sold with the land, or unripe fruit is sold together with the land and the trees, a difficult question has arisen as to the proper application of the present law to the unharvested crops or the unripe fruit.

"The Bureau of Internal Revenue has ruled that, whether or not such crops or fruit are regarded as a part of the real estate under local law, they constitute property held 'primarily for sale to customers in the ordinary course of his (the taxpayer's) trade or business' and thus, under the provisions of section 117 (j), any gain on the sale of the unharvested crops or unripe fruit is to be separately determined and treated as ordinary income instead of as a capital gain. In several decisions the Tax Court (with some members dissenting) has taken a similar view, but two district courts have held that such fruits or crops constitute 'property used in the trade or business' so that a gain from a sale of the land, trees, and fruit would be treated as a capital gain with the result that the entire gain from the sale of such property would constitute ordinary income.

"Your committee believes that sales of land together with growing crops or fruit are not such transactions as occur in the ordinary course of business and should thus result in

Revenue had taken an erroneous view of the prior statute. Indeed, the benefits of capital gain treatment were extended, not because the crop is used in a trade or business, but because the sale does not occur in the ordinary course of business—a distinction which is not the standard for other kinds of property. See *Williams v. McGowan*, 152 F. 2d 570 (C. A. 2d), involving the sale of an entire business, including the stock in trade. Second, the amendments to the Code, instead of being retroactive, as might be expected if Congress had viewed the new language as being declaratory of existing law, were given a prospective capital gains rather than in ordinary income. Section 323 of the bill so provides.

“Your committee recognizes, however, that when the taxpayer keeps his accounts and makes his returns on the cash receipts and disbursements basis, the expenses of growing the unharvested crop or the unripe fruit will be deducted in full from ordinary income, while the entire proceeds from the sale of the crop, as such, will be viewed as a capital gain. Actually, of course, the true gain in such cases is the difference between that part of the selling price attributable to the crop or fruit and the expenses attributable to its production. Therefore, your committee’s bill provides that no deduction shall be allowed which is attributable to the production of such crops or fruit, but that the deductions so disallowed shall be included in the basis of the property for the purpose of computing the capital gain.

“The provisions of this section are applicable to sales or other dispositions occurring in taxable years beginning after December 31, 1950.

“The revenue loss under this provision is expected to be about \$3 million annually.”

tive application only. While the taxpayer, of course, contends (Br. 29) that it was not necessary to make the statute retroactive, the failure of Congress to do so where growing crops are involved is to be contrasted with the retroactive amendment made by Section 324 of the 1951 Act to extend Code Section 117 (j) to livestock held for breeding or dairy purposes. Third, the extension of capital gain treatment to unharvested crops was accompanied by withdrawing a taxpayer's right to deduct from ordinary income, whether in the same or preceding taxable years, the expenses incurred in the production of the unharvested crop. This plainly indicates that the statute was being extended to embrace a new area—an extension which could not fairly be granted without also altering the right to deduct crop expenses. It stands in marked contrast to what the taxpayer contends was the Congressional intent prior to 1951, namely, that while permitting the crop expenses to be deducted from ordinary income, Congress had already extended capital gain treatment to unharvested crops. Further, the Senate Finance Committee recognized that because of the change in the law (fn. 10, *supra*, p. 40) "The revenue loss * * * is expected to be about \$3 million annually." As the court below stated (R. 133): "Here is a clear recognition that § 117 (j) (1) prior to amendment is

as interpreted by the Tax Court and this opinion." ¹¹

In the light of the foregoing, we submit that when taxpayers first began to urge that the adoption of Code Section 117 (j) operated to extend capital gain treatment to growing crops if transferred to a purchaser in a single sale of the farm land, the Bureau of Internal Revenue properly ruled that the statute did not contemplate such a result: L. T. 3815, 1946-2 Cum. Bull. 30¹² and the courts below were correct in sustaining this ruling.

The matters discussed above also demonstrate why the contrary decision in *Owen v. Commissioner*, 192 F. 2d 1006 (C. A. 5th), and in *McCoy*

¹¹ In Miller, *The "Capital Asset" Concept: A Critique of Capital Gains Taxation*, 59 Yale L. J. 837 (1950), referring to Code Section 117 (k), which extended capital gain treatment to timber owners, it is stated (fn. 142, p. 866):

"Such legislative favoritism does not imply that the prior judicial interpretations of § 117 (a) were erroneous but indicates merely that the substantial benefits accorded to sales of capital assets are a standing invitation to interested groups with sufficient influence to secure lower taxes for themselves without regard to the policies which supposedly justify the special treatment of capital transactions."

¹² The taxpayer states (Br. 22-23) that prior to the ruling in L. T. 3815, *supra*, a farmer who sold farm land was not required to report as ordinary income the profit allocable to a growing crop. This statement stands unsupported by any ruling, decision, or other authority. Equally unwarranted is the taxpayer's attempt to suggest that L. T. 3815 was a reversal in position (Br. 23) "inspired" by *Williams v. McGowan*, 152 F. 2d 570 (C. A. 2d), a decision which is not even mentioned in the ruling.

v. *Commissioner*, 192 F. 2d 486 (C. A. 10th), are erroneous. For example, in the *Owen* case, *supra*, once the court assumed, quite mistakenly, that the operation of Section 117 (j) was conclusively governed by the fact that Florida law characterized the unharvested citrus crop as an inseparable part of the real estate, it was almost inevitable that the incorrect tax result would be reached. Furthermore, it is very difficult to reconcile the court's recognition that the growing fruit was being held (192 F. 2d at p. 1009) "for a potential future sale" with its ultimate conclusion that the fruit was not being held primarily for sale to customers. How property which is being held for even "potential" sale, and only for that purpose, could also be "used" in the trade or business, is a matter which the court does not answer. Also, in the *McCay* case, *supra*, the court, paying little heed to the statutory exclusion of property held for sale to customers, assumed that an unharvested crop was an inseparable element of the land because Kansas law so regarded it, and that Section 117 (j) applied as well to the crop as to the land.

Other authorities relied on by the taxpayer are not at all persuasive here. Thus, in *Butler Consolidated Coal Co. v. Commissioner*, 6 T. C. 183 (Pet. Br. 17-18), the taxpayer was in the business of mining and selling coal. On a sale of coal property, at which the taxpayer had abandoned mining operations many years before, it was held that the coal in place was a capital asset

and that a capital loss was incurred. The decision rested on the ground that the taxpayer there was in the business of mining and selling coal, and was not in the business of selling unmined coal. The situation is not at all comparable to that presented here where the taxpayer's business was growing and selling oranges and where the oranges which were sold, though not fully mature, were grown by the taxpayer. The *Butler* case would have been analogous only if the subject of the sale had included some coal which had been severed but which was not yet in a saleable condition because still uncleaned and unsorted. Had the latter been the situation in the *Butler Coal* case, we believe that the profit attributable to the partially mined coal would have been taxable as ordinary income.

In *Carroll v. Commissioner*, 70 F. 2d 806 (C. A. 5th), and *Camp Manufacturing Co. v. Commissioner*, 3 T. C. 467 (Pet. Br. 18), the taxpayers had been in the business of cutting timber from their own lands and fabricating it into lumber. Sale of the land and growing timber was held to be the sale of a capital asset. Those cases are distinguishable, as the Tax Court pointed out (R. 48), because there the taxpayers were in the business of selling lumber which they had fabricated and were not in the business of growing timber for sale, while here the growing crop represented the efforts of the business in which the taxpayer was engaged.

II

ALTERNATIVELY, THE CROP WAS NOT HELD FOR 6 MONTHS AND CODE SECTION 117 (j) IS NOT APPLICABLE TO EXTEND CAPITAL GAIN TREATMENT TO THE PROFIT

Even if the decisions below should be deemed incorrect in holding that the growing crop did not satisfy the definition of Section 117 (j) (1) because it was not used in the trade or business and because it was being held primarily for sale to customers, there is, as held by the Court of Appeals, an alternative reason why that section is not applicable. That is, no property, whatever its character, can qualify under the Section 117 (j) (1) definition unless it has been held by a taxpayer for at least 6 months. In the present case, the existing orange crop had not been held by the taxpayer for the requisite period and, accordingly, Section 117 (j) (1) is inapplicable.

The earliest point in the year when the fruit crop could possibly be thought of as having an existence is when the blossoms form on the trees. This the Tax Court found to be (R. 26) "in the spring" and the testimony, more precisely, would place the blossoming and the forming of the small fruit in May (R. 80). As a practical matter, however, the annual crop probably starts its existence later, for a considerable portion of the small fruit drops from the trees during May and June, and after that the crop is said to become "set" in the area

where this particular grove was situated. (R. 26.) Thus, whether the fruit is considered as coming into existence at the time of blossoming or later at the time when the crop becomes "set," it is clear that the crop had not been in existence for 6 months and could not have been held by the taxpayer for 6 months on August 10, 1944, when the agreement of sale was concluded or on September 1, 1944, when the purchase price was paid. Accordingly, even if the taxpayer's contention to the effect that the oranges were not being held by her for sale to customers in the ordinary course of her trade or business could be accepted, the fact that the crop had not been held for 6 months prior to the sale would, under the express terms of Section 117 (j), be a complete bar to the application of that section.

CONCLUSION

The decision of the Court of Appeals is correct and should be affirmed.

Respectfully submitted,

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Special Assistants to the Attorney General.

JANUARY 1953.

APPENDIX

INTERNAL REVENUE CODE:

SEC. 117. CAPITAL GAINS AND LOSSES.

(a) [as amended by Section 115 (b), Revenue Act of 1941, c. 412, 55 Stat. 607, and Section 151 (a), Revenue Act of 1942, c. 619, 56 Stat. 798] *Definitions*.—As used in this chapter—

(1) *Capital Assets*.—The term “capital assets” means property held by the taxpayer (whether or not connected with his trade or business), but does not include stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business, or property, used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 23 (1), or an obligation of the United States or any of its possessions, or of a State or Territory, or any political subdivision thereof, or of the District of Columbia, issued on or after March 1, 1941, on a discount basis and payable without interest at a fixed maturity date not exceeding one year from the date of issue, or real property used in the trade or business of the taxpayer;

(j) [as added by Section 151 (b), Revenue Act of 1942, *supra*, and amended by Section 127 (b), Revenue Act of 1943, c. 63, 58 Stat. 21] *Gains and Losses From In-*

voluntary Conversion and From the Sale or Exchange of Certain Property Used in the Trade or Business.—

(1) *Definition of Property used in the Trade or Business.*—For the purposes of this subsection, the term “property used in the trade or business” means property used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 23 (1), held for more than 6 months, and real property used in the trade or business, held for more than 6 months, which is not (A) property of a kind which would properly be includible in the inventory of the taxpayer if on hand at the close of the taxable year, or (B) property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business. Such term also includes timber with respect to which subsection (k) (1) or (2) is applicable.

(2) *General Rule.*—If, during the taxable year, the recognized gains upon sales or exchanges of property used in the trade or business, plus the recognized gains from the compulsory or involuntary conversion (as a result of destruction in whole or in part, theft or seizure, or an exercise of the power of requisition or condemnation or the threat or imminence thereof) of property used in the trade or business and capital assets held for more than 6 months into other property or money; exceed the recognized losses from such sales, exchanges, and conversions, such gains and losses shall be considered as gains and losses from sales or exchanges of capital assets held for more than 6 months. If such gains do not exceed such losses, such gains and losses shall not be considered as gains and losses

from sales or exchanges of capital assets.
For the purposes of this paragraph:

(A) In determining under this paragraph whether gains exceed losses, the gains and losses described therein shall be included only if and to the extent taken into account in computing net income, except that subsections (b) and (d) shall not apply.

(B) Losses upon the destruction, in whole or in part, theft or seizure, or requisition or condemnation of property used in the trade or business or capital assets held for more than 6 months shall be considered losses from a compulsory or involuntary conversion.

* * * * *

(26 U. S. C. 1946 ed., Sec. 117.)

IN THE
Supreme Court of the United States

October Term, 1952

No. 290

ERNEST A. WATSON and M. GLADYS WATSON,
Petitioners

VS.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

On Writ of Certiorari to the United States
Court of Appeals for the Ninth Circuit

BRIEF OF AMICUS CURIAE

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BRIEF OF AMICUS CURIAE

To the Honorable the Chief Justice and the Associate
Justices of the Supreme Court of the United States:

The undersigned herewith respectfully file with this Honorable Court this brief as amicus curiae. The petitioners' written consent to such filing is filed herewith; and respondent's written consent has been previously filed with the Clerk of the Supreme Court under date of December 30, 1952.

**Preliminary Statement—
Interest as Amicus Curiae**

The issues raised in this cause are of concern to various parties represented by the undersigned by virtue of causes presently in litigation in the Tax Court of the United States⁽¹⁾, and like matters presently involved in pre-litigation stages with the Internal Revenue Service. The instant cause involves the great citrus fruit growing industry of the State of California; and certiorari was granted, we presume, largely because of a conflict of decisions in the Courts of Appeals, decisions contrary to that of the Ninth Circuit in the instant case

(1)

Ann Edwards Trust, L. C. Edwards, Jr., Trustee, vs. Commissioner of Internal Revenue, Docket No. 25471;

Nancy Edwards Trust, L. C. Edwards, Jr., Trustee, vs. Commissioner of Internal Revenue, Docket No. 25472;

W. F. Edwards vs. Commissioner of Internal Revenue, Docket No. 30884;

L. C. Edwards, Jr., vs. Commissioner of Internal Revenue, Docket No. 30885.

Other cases, which have been considered by the respondent to be related (contrary to our view) are:

Triple E. Development Company vs. Commissioner of Internal Revenue, Docket No. 26008;

Louise H. Edwards vs. Commissioner of Internal Revenue, Docket No. 24909;

Triple E Development Company vs. Commissioner of Internal Revenue, Docket No. 24910;

W. F. Edwards vs. Commissioner of Internal Revenue, Docket No. 24911;

Katherine T. Edwards vs. Commissioner of Internal Revenue, Docket No. 24912;

L. C. Edwards, Jr., vs. Commissioner of Internal Revenue, Docket No. 24913;

M. E. Price vs. Commissioner of Internal Revenue, Docket No. 24914.

having been previously rendered by the Court of Appeals for the Tenth Circuit, and the Court of Appeals for our own Circuit, the Fifth. This latter concerned the great citrus growing industry of the State of Florida, and we thus have the exact counterparts in opposition before this Court.

Frankly we see no essential difference which would distinguish the instant case from those which were the basis of contrary decisions, and certainly we do not apprehend that petitioners' counsel will not vigorously and thoroughly present to this Court all facets of the case in brief and argument. We do feel that it is in the best interests of our clients and of aid to this Court to try to present an analysis by local counsel of the decisions of our courts in the Fifth Circuit which are opposed to the decision of the Ninth Circuit in the instant case.

Statement of the Question Involved

At the risk of being incautiously brief, we believe the proposition before this Court for solution is a very simple one.

Facts. The owner of a citrus grove has operated it in his business, which was the production and sale of ripe fruit, and has held the grove for more than six months. He then sells it—including in the sale the unmarketable immature citrus fruit then growing on the trees—for a single lump-sum consideration.

Problem. Is the immature citrus fruit on the trees at the time of sale a part of the realty sold and

"net held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business"? If it is, it is entitled to capital gains treatment under §117(j) of the Internal Revenue Code.

Statute Involved

The pertinent parts of §117(j) of the Internal Revenue Code are these:

(j) Gains and Losses From Involuntary Conversion and From the Sale or Exchange of Certain Property Used in the Trade or Business.—

(1) Definition of property used in the trade or business.—

For the purposes of this subsection, the term "property used in the trade or business" means property used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 23 (1), held for more than 6 months, and real property used in the trade or business, held for more than 6 months, which is not (A) property of a kind which would properly be includible in the inventory of the taxpayer if on hand at the close of the taxable year, or (B) property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business * * *

(2) General Rule. — If during the taxable year, the recognized gains upon sales or exchanges of property used in the trade or business, * * * exceed the recognized losses from such sales or exchanges * * * such gains and losses shall be considered as gains and losses from sales or exchanges of capital assets held for more than 6 months. If such gains do not exceed such losses, such gains and losses shall not be considered as gains and losses from sales or exchanges of capital assets."

* * *

Outline of Argument

I. Under Section 117(j), growing citrus fruits are "real estate" until actually or constructively severed.

A. As the Internal Revenue Code does not define real property, the status of the fruit as realty or personalty is to be determined by local law.

Owen vs. Commissioner, 192 F. 2d 1006.

B. Under both California and Florida law, crops of fruit growing on the trees, whether mature or immature, are in general a part of the realty until actually or constructively severed.

Owen vs. Commissioner, 192 F. 2d 1006

Adams vs. Adams, 158 Fla. 173, 28 So. 2d 254

Wilson vs. White, 161 Cal. 453, 119 Pac. 895

Sweet vs. Watson's Nursery, 92 P. 2d 812

Watson vs. Commissioner, 197 F. 2d 56, 57

C. If there were a federal common law applicable, the result would be the same.

1. No federal general common law.

Erie R. Co. vs. Tompkins, 304 U. S. 64, 78.

Western Union Telegraph Co. vs. Call Publishing Co., 181 U. S. 92, 101.

2. Ungathered crops are part of the realty.

Viterbo vs. Friedlander, 120 U. S. 707, 730.

II. Under Section 117 (j), unsevered citrus fruits which are disposed of as part and parcel of the sale of the land and trees, are "not . . . property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business."

- A. The terms "capital assets" and "property used in trade or business" are to be broadly construed.

Homer Hendricks, *Federal Income Tax:*

Capital Gains and Losses, 49 Harv. Law Rev. 262, 263.

Thomas E. Wood, 16 TC 213, 219-220.

- B. If the property sold is realty, and the taxpayer does not sell realty, nor hold it for sale to customers in the ordinary course of his trade or business, its sale is not within the exception in section 117(j).

Owen vs. Commissioner, 192 F. 2d 1006

McCoy vs. Commissioner, 192 F. 2d 486

Irrgang vs. Fahs, 94 Fed. Supp. 206

- C. It is the property which is sold, at the time it sold, and not what it potentially might become, that is classified in accordance with section 117(j).

Owen vs. Commissioner, 192 F. 2d. 1006

McCoy vs. Commissioner, 192 F. 2d 486

Irrgang vs. Fahs, 94 Fed. Supp. 206

United States vs. Bennett, 186 F. 2d 407

Argument

As these cases have sifted through the courts it has appeared that respondent's contentions have been limited to the two to which we referred above:

1. The immature citrus fruit growing on the trees is not a part of real property, and
2. That even if real property, these growing crops are nevertheless property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business.

We believe that these contentions are contrary to a proper construction of §117(j) of the Internal Revenue Code, that immature citrus fruits growing on the trees are real property; and that, furthermore, they are not property held by taxpayers involved primarily for sale to customers in the ordinary course of their trade or business.

- I. Under Section 117(j), growing citrus fruits are "real property" until actually or constructively severed.

When the taxing statute uses words of local or common law significance, without definition, it seems plain that it was the intention of Congress to have the local law determine the property rights which were to be taxed, leaving the manner of taxation to Federal law. The Court of Appeals for the Fifth Circuit so held in *Owen vs. Commissioner*, 192 F. 2d 1006, 1008:

"As the Internal Revenue Code does not define real property, the status of the fruit as realty or personality is to be determined by the law of Florida."

This court, and other Federal courts, have applied the same principle in similar situations, *Magruder vs. Supplee*, 316 U. S. 394, 396; 86 L. ed. 1555, 1558; *National Memorial Park vs. Commissioner of Internal Revenue*, 145 F. 2d 1008, 1014 (CA, 4) cert. denied, 324 U. S. 858, 89 L. ed. 1416.

Under both California and Florida law it is settled that crops of fruit, whether mature or immature, which are growing on the trees are a part of the realty unless actually or constructively severed. The decision of the Court of Appeals in the instant case apparently does not quarrel with this proposition, and assumes, arguendo, that it is correct. *Watson vs. Commissioner*, 197 F. 2d 56, 57. When dealing with the transaction here involved, the sale of an orange grove, there seems to be no doubt that the Supreme Court of California would determine under its decisions that the crop constitutes a part of the realty, absent a constructive severance. *Wilson vs. White*, 161 Cal. 453, 119 Pac. 895.

The Court of Appeals for the Fifth Circuit very firmly stated the effect of the Florida law:

"The Florida rule is that crops of fruit growing on trees, whether mature or immature, are in general a part of the realty until severed."

Owen vs. Commissioner, 192 F. 2d 1006, 1008.

This case and *Irrgang vs. Fahs*, 94 Fed. Supp. 206, decided in the United States District Court for the Southern District of Florida in 1950, both rely for this proposition on the latest decision of the Supreme Court of Florida, *Adams vs. Adams*, 158 Fla. 173, 28 So. 2d 254, 255, where the court said:

“* * * Crops unseparated from the tree or vine are a part of the real estate till separated and follow the latter unless in terms reserved by the seller. We find some exception to this rule, but it is the one generally approved throughout the country.”

It is obvious that any appendage to the real property may be actually or constructively severed from it, and as such become in the nature of personalty. This is not a situation unique to growing crops. As a matter of fact, under some circumstances the trees themselves might be actually or constructively severed, either as crops or timber. The case of *Sweet vs. Watson's Nursery*, 92 Pac. 2d 812, 815, dealt with orange trees in their nursery or pre-production stage, and there applied all the usual rules concerning growing crops.

Were there a Federal common law applicable under which a definition of real estate could be obtained, the result would be the same. It has generally been stated, of course, that there is no Federal general common law. *Erie R. Co. vs. Tompkins*, 304 U. S. 64, 78; 82 L. ed. 1188, 1194; *Western Union Telegraph Co. vs. Call Publishing Co.*, 181 U. S. 92, 101; 45 L. ed. 765. To the extent that it is necessary to a construction of Federal statutes it is sometimes assumed that there is. *McNally vs. Hill*, 293 U. S. 131, 136; 79 L. ed. 241. If this were so, the only pronouncement on this subject which we are aware this court has made is in *Viterbo vs. Friedlander*, 120 U. S. 707, 730; 30 L. ed. 784, where this court said in a case involving the civil law:

“There is no doubt that by the civil law, as by the common law, crops so long as they are standing and ungathered are part of the land to which they are attached.”

As stated in *McCoy vs. Commissioner*, 192 F. 2d 486, 487, (CA, 10), this is the "general rule"; and, as that decision states—

"... there is logic and reason behind this. Growing crops depend for their life upon the real estate of which they are a part. They draw their food and sustenance therefrom. Separate them from the real estate and they cease to exist and die. Except as a part of the real estate, a growing immature crop has no value."

(at page 488)

That logic is sound, not only to demonstrate that there is reason in the rule which considers growing crops as real estate, but to demonstrate that as growing crops, they are distinctly different from the ultimate product which the grove owner later severs and holds for sale, and on the sale of the grovelands must be classified as an inseparable part of the assets which under §117(j) are subject to taxation on a capital gains basis.

- II. Under Section 117 (j), unsevered citrus fruits which are disposed of as part and parcel of the sale of the land and trees, are "not . . . property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business."

Subsection 117(j) borrows the terminology which is pertinent here from subsection 117(a)(1). This subsection defines "capital assets", and excludes from that classification—

"... property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business . . ."

The legislative history of this phraseology conclusively demonstrates the desire of the Congress to limit this

exclusion from "capital assets" and "property used in the trade or business" to its narrowest possible interpretation.

The quoted exclusion first appeared in the Revenue Act of 1924 (Section 208 (8)) with the emphasized words omitted. It was amended by the Revenue Act of 1934.

The capital gains and losses provisions of the Revenue Act of 1934 were substantially affected by two considerations:

- (1) In the depression period capital losses were a much more important consideration than capital gains.
- (2) The pressure for revenues in a depression period required that ordinary losses be limited to a minimum, and the effect of capital losses on revenues be likewise limited.

To some extent these considerations were brought into the Revenue Act of 1932 (Homer Hendricks, *Federal Income Tax: Capital Gains and Losses*, 49 Harv. Law Rev. 262, 263; *House Report No. 708, 72nd Congress, First Session, Cumulative Bulletin 1939-1, Part 2*, p. 465; *Senate Report No. 665 72nd Congress, First Session, Cumulative Bulletin 1939-1, Part 2*, pp. 503-504, 508-510). They are also involved in the Revenue Act of 1934, which severely limited the deductibility of all capital losses (Hendricks, *supra*, 262). (2). It was therefore considered

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- (2) "Congress was prompted to this action by the disclosure that several prominent financial leaders had paid no Federal income tax during 1930, 1931 and 1932, because their losses on sales of securities offset their very substantial income from other sources." *Thomas E. Wood*, 16 TC 213, 219-220. This situation had actually preceded the enactment of the 1932 Act but was still reverberating (*Cumulative Bulletin, 1939-1, part 2*, pp. 465-466; pp. 503-504, 508, 510).

advisable to define "capital assets" as *broadly* as possible; and that Congressional intention is abundantly clear from the committee reports. The following statements are from those reports as reprinted in *Cumulative Bulletin 1939-1*, Part 2:

"Subsection (117) (b) defines capital assets. It will be noted that the definition includes all property, except as specifically excluded".*)
(p. 577, *House Report*).

"... the definition of capital assets has been slightly revised to prevent tax avoidance by excluding from the category of a capital asset 'property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business', instead of merely 'property held by the taxpayer primarily for sale in the course of his trade or business'. (p. 595, *Senate Report*).

"The Senate amendment confines the exclusion to property held primarily for sale to customers in the ordinary course of the taxpayer's trade or business, thus making it impossible to contend that a stock speculator trading on his own account is not subject to the provisions of section 117." (p. 632, *Conference Report*).

While times may have changed, the statute remains as it was in 1934. It was intended to then provide, and it now provides, the *broadest possible definition of capital assets*. This intention necessarily carries over into its counterpart in subsection 117(j).

Considering then the application of the statute to this factual situation, we are confronted with two questions:

*) This is also the language of the Regulations. Section 29.117-1.

1. What was the *property* sold?
2. Does that property fit within the *exclusion* of the statute?

The property sold. As we have demonstrated in the first section of this brief, the property sold was *real property*—all of it.

This Court has never reviewed the “fragmentation” doctrine of the sale of an operating business entity, as expressed in *Williams vs. McGowan*, 152 F. 2d 570 (CA, 2). We do not think it essential to a decision for the petitioners in this case that it do so now. That case held that the sale of a going business was not the sale of a single piece of property for income tax purposes, but that the business must be comminuted into its fragments and these would be separately matched against the statutory definitions of Section 117. Judge Frank’s strong dissenting opinion (at page 573) is persuasive that a different result is more in harmony with the intent of the taxing statute. After all, Section 117 does not eliminate transactions from taxation; it merely classifies transactions and then determines the manner in which they shall be taxed. It is difficult to apprehend that Congress really intended to tax the sale of shares in an incorporated business on one basis, and the sale of an unincorporated business on an entirely different basis; or, as the *Williams* case holds, that Congress intended to tax the sale of a partnership interest on one basis and the sale of the same entire business on another basis.

But in the instant case, the respondent desires, not only to do violence to logic, but to nature. Here, he argues, we must apply the fragmentation doctrine so as to split off from the asset, that part which cannot

exist without sustenance from the remainder of the asset, the trees and the land—the growing immature fruit. We feel that the application of metaphysical principles to the practical science of taxation should end well before this point is reached.

We have already referred to the analysis of Judge Huxman on this point in the *McCoy* case (192 F. 2d 486, 488, CA, 10). The opinion of Judge Strum in the *Owen* case (192 F. 2d 1006, 1009) demonstrates the same point:

"The severance made by the Commissioner for tax purposes was purely an artificial one, which did not in fact occur. While on the trees and unsevered, the fruit was as much a capital asset as the trees and land. The fruit was as much a part of the trees as the leaves and branches."

Thus there was a single and entire property sold which cannot be logically, tangibly, physically or commercially "fragmented".⁽³⁾ That property we have demonstrated to be *real property*. The respondent has never disputed in these cases that the taxpayers have never held for sale to customers in the ordinary course of their trade or business any real property. Thus, the sale cannot be within that exception to the application of subsection 117(j).

The analogy attempted by the Court of Appeals in the instant case (197 F. 2d at p. 57) while ingenious, is not apt. The ten-story cooperative apartment venture (an anomaly in real property law anyway) does not bear the physical and natural relationship to the department store that the growing fruit does to a tree. But

(3) It is a well known fact, demonstrated by evidence in other cases, that—unlike some other fruits—a citrus fruit will not develop further after being severed from the tree. It can only reach maturity while a part of the tree.

if it did, there is a further egregious error in that court's opinion in its application of the statute to horticultural realities.

The Statutory Exclusion. A fruit tree is a unique production machine. It is a bundle of potential crops; and from that fact, it derives all of its value. The potential crop which is presently visible on the tree is no different from those which will follow it, except that it is the potential which will first become farm produce. But it is *not* farm produce until, at the very earliest, it attains maturity on the tree. Cultivation may increase this year's potential; and fertilizing may increase the following year's potential (Tr. 123), perhaps to the detriment of some later potential (Tr. 123-124). It is this bundle of potential crops—including the visible evidence of that which will first become farm produce—which is sold when the tree is sold. There is no basis for distinguishing between any of the potential crops. If one is to be "fragmented" out of the tree, as being "*property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business,*" then *all* must be (an obviously absurd result) for the only *property held* at the time of sale is the land and trees.

It is true that there are infrequent "sales" by some growers of potential crops prior to their maturity (e. g., Tr. 119, 122-123); but these involve the condition that the growing immature fruit stay on the tree under either the buyer's or seller's management until maturity (Tr. 123). Actually they are in the nature of payments in advance for the mature product if and when it develops, and including, in effect, an interest in the land and trees which permit that growth to maturity. Problems of "constructive severance" might arise. Whether such deviations from the normal practice might present

new questions for consideration is immaterial to a decision of this case. It is the *taxpayers'* trade or business which is the criterion; and in the instant case—as in the usual case—that business was limited to the production and sale of *ripe* citrus fruits, not of a mere potential crop which was in *and* a part of the citrus tree.

It is the character of the property as it is held at and preceding the time of the sale which is the statutory criterion. That is plainly the wording of the statute. Respondent would have the exclusion refer to property which if continued to be held by the taxpayer, could *ultimately* change in form and substance and become property held for sale to customers in the ordinary course of his trade or business. The courts have justifiably been disinclined to so distort the statute. *United States vs. Bennett*, 186 F. 2d 407, 410; *Owen vs. Commissioner*, 192 F. 2d 1006, 1009.

From this arises another comment concerning the opinion of the Court of Appeals in the instant case. That opinion reads into the statute a requirement that there must be an intention to sell the real property (including the immature crop growing on the trees) for more than six months before its actual sale. On this the court bases its major disagreement with the Fifth Circuit in the *Owen* case (192 F. 2d 1006; cited *Watson* case, 197 F. 2d 58-59).

To begin with, this is a misinterpretation of the opinion in the *Owen* case. The Fifth Circuit was considering the character of the *property* held for sale, not the intention of the owner concerning its ultimate disposition. Furthermore, the opinion of Chief Judge Denman in the instant case would require the exclusion in the statute to be rewritten in somewhat the following terms:

"... real property used in the trade or business, which, for more than six months, the taxpayer has not intended to sell to customers in the ordinary course of his trade or business."

Quite naturally we prefer it as it is written and, as we think, the Court of Appeals for the Fifth Circuit properly interpreted it.

In *Irrgang vs. Fahs*, 94 F. Supp. 206, 211, the court there pointed out that a holding of the land and trees for more than six months was a holding of the entire property for that period, inasmuch as the growing citrus fruit was an integral part of it.

As we have pointed out, a tree is a production facility which harbors only a *potential* product up until the day the complete product is produced, severed and delivered. Particularly in the case of citrus fruits, which do not develop after severance, a potential can never be a reality until it has matured and is delivered by harvesting. The potential fruit as it appears on the tree before maturity is merely a part of the tree which develops into the ultimate product, mature fruit; and is no more held for sale to customers in the ordinary course of the citrus producing business than is the fertilizer, water, sunshine, labor and other items which are used by the tree in producing the final product, farm produce, ultimately resulting from the entire growing, transformation and development process. The tree itself is one of the raw materials from which the finished product is finally formed. No crop comes into being, as such, until it is harvested. Its existence as a crop is merely potential or "prospective" (Regulations 111, Section 29.23(e)-5), until it is saleable in the citrus producer's hands.

It is obvious, therefore, that during the entire growing process, there is a single asset in the tree. Any potential fruit developing on that tree is "as much a part of the tree as the leaves and branches", *Owen vs. Commissioner*, 192 F. 2d 1006, 1009. A distinction between crop and tree at that point is a purely artificial one.

With regard to the amendment to Section 117(j) by the Revenue Act of 1951, we shall comment but briefly. The Court of Appeals for the Tenth Circuit in the *McCoy* case, 192 F. 2d 486, 488-489, concluded that the Senate Committee Report makes it clear that the purpose of the amendment was to clarify existing law. The third paragraph of that report, although couched in inartistic language, certainly conveys that meaning. The Court of Appeals in the instant case points out that the report contains a statement that the provision will result in a revenue loss of \$3,000,000 annually, and thus arrives at an opposite conclusion. Whether this revenue loss results from a comparison with existing law, or with some version which might have been suggested by the Treasury Department as more consonant with its views, is not clear. The Court of Appeals for the Fifth Circuit saw in the Act no interpretation of existing law (192 F. 2d at 1009, note 1) and except to the extent referred to in the *McCoy* case above, this seems a proper conclusion.

Summary

We respectfully suggest that the "fragmentation" doctrine, if approved at all by this Court, be stopped at some point far short of a conflict with the laws of nature. To carry it to the length of requiring the separation into two "properties" of a distinct natural and physically inseparable unit of trees and growing fruit crops seems absurd. (4)

Nor does there seem to be any justification for determining that a citrus fruit grower who had never sold anything but ripe fruit, held non-edible and immature fruit *primarily* for sale to his *customers* in the ordinary course of his business.

Respectfully submitted,

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(4) We might suggest that respondent is the source of his own discomfort. Had not the inventorying of growing crops been prohibited by the Internal Revenue Bureau (see *Irrgang vs. Fahs*, 94 F. Supp. 206; 211), there would have been no difficulty in this case; except, of course, that that would have led to annual litigation over valuations with practically all farmers.

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IN THE
Supreme Court of the United States

October Term, 1952

No. 290.

ERNEST A. WATSON and M. GLADYS WATSON,
Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR REHEARING.

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Respondent.

PETITION FOR REHEARING.

*To the Honorable the Chief Justice and the Associate
Justices of the Supreme Court of the United States:*

Ernest A. Watson and M. Gladys Watson, petitioners in this cause, respectfully petition the Court for rehearing, and present the following grounds in support of this petition:

I.

**The Basis of the Decision Is in Conflict With Previous
Decisions of This Court.**

The decision of the majority of the Court places its chief reliance on a legislative enactment made in 1951 as an interpretation of a statutory phrase dating back to at least 1924 (Revenue Act of 1924, Sec. 208(a)(8)). Amendments designed to further restrict the application of that phraseology (as it appears in Sec. 117(a)(1)); were made by the Revenue Act of 1934, and further

amendments occurred in the Revenue Act of 1938, c. 289, 52 Stat. 447, and the Revenue Act of 1942, c. 619, 56 Stat. 798.

The amendment of 1938 excluded from capital assets treatment, property such as buildings, the trees in an orchard or orange grove and similar real property improvements, all depreciable property used in a business. This was reversed by the 1942 Act. But this four-year hiatus in the treatment of perennial plantings would in no wise affect the question of whether growing annual crops sold with the real property should be given, along with the real property, capital gains treatment. Thus, except for a four-year hiatus with respect to one type of growing crops (those on perennial plantings) the Treasury Department was in a position to raise the question of the taxable status of growing crops over a period of at least 22 years, until 1946 when it made its pronouncement in I. T. 3815 (1946-2 Cum. Bull. 31). The comparison of the wave of litigation following that pronouncement with the absolute lack of any litigated cases prior to 1946 on the subject conclusively demonstrates that the position of the Bureau in 1946 was a complete reversal of the position that it had held in interpreting the statute for 22 years.

It was only subsequent to that change in the Bureau's position, and the extensive litigation which it engendered, that the Congress passed in the Revenue Act of 1951 (sec. 323), its approval of the inclusion of growing crops sold along with the realty for capital gains treatment under Section 117(j) of the Internal Revenue Code.

We thus have a situation where a congressional act of 1924, was given a contemporaneous interpretation by its administrators which was followed for 22 years. This

Court in *Fogarty v. United States*, 340 U. S. 8, 13-14, 95 L. Ed. 10, 15, declined to supplant the contemporaneous intent of an earlier Congress with an intent implied from later congressional activity with regard to the same subject matter. We respectfully submit that a contrary result was reached by a majority in this case.

The fact that an assumed history and purpose of the 1951 amendment should not be decisive of the result in this case is demonstrated by the fact that the majority and minority opinions are exactly opposed in their interpretation of the congressional intent in enacting it. Furthermore, the courts of appeals in the Tenth Circuit (*McCoy v. Commissioner*, 192 F. 2d 486, 488-489), and in the Ninth Circuit (*Watson v. Commissioner*, 197 F. 2d 56, 58), were also directly opposed concerning that intention. The Fifth Circuit in *Owen v. Commissioner*, 192 F. 2d 1006, 1009, apparently saw no clear congressional intention in the 1951 amendment, one way or another. Thus of the 18 appellate justices and judges who have heard and decided these cases, 9 said that Congress in 1951, intended to change the law, 6 said it did not, and 3 said Congress did not express itself one way or another.

Mr. Justice Jackson concurring in *United States v. Public Utilities Commission*, October Term, 1952, No. 205, Decision April 6, 1953; 97 L. Ed. (N. S.) 637, 649, referred to his preference for a process of decision by "analysis of the statute instead of by psychoanalysis of Congress." The majority in the instant decision has, we respectfully submit, utilized the latter process; and it has not only determined inferentially what was in the mind of the 1951 Congress, but has imposed that legislative intention on the many Congresses which dealt with the statutory wording in question back to the passage of the 1924 Act.

II.

**Contrary Decisions of This Court Concerning
Administrative Interpretation.**

We have referred above to the fact that the 1946 interpretation of the Bureau of Internal Revenue (I. T. 3815, 1946-2 Cum. Bull. pp. 30-31), represented a change in position. As we have stated, litigation of this question came subsequent to the issuance of that ruling by the Income Tax Unit of the Bureau. It is important to realize that all of these questions concerning the allocation of a portion of a lump-sum purchase price to growing crops contain the problem of *valuation* as well as the problem of allocation. Even if taxpayers had all acquiesced in the proposition contended for by the Bureau in its 1946 ruling prior to the date of that ruling, it is apparent that at least the question of the valuation of some of the growing crops involved would have been brought before the courts. Yet there is not a single case involving tax years other than those open for examination at the time of the 1946 promulgation, which raises either the question of allocation or valuation of growing crops included in a lump-sum sale.

There was thus an administrative interpretation consonant with the taxpayers' position, and contemporaneous with the statutory enactment here being interpreted over a long period of years.

Such an administrative interpretation is entitled to substantial weight (*Lykes v. United States*, 343 U. S. 118, 126-127, 96 L. Ed. 791, 800, and cases cited; *Universal Battery Co. v. United States*, 281 U. S. 580, 583, 47 L. Ed. 1051, 1055), and such administrative construction may be implied from inaction as well as from positive

assertion (*Federal Trade Commission v. Bunte Brothers, Inc.*, 312 U. S. 349, 351, 352, 85 L. Ed. 881, 884; *United States v. American Union Transport*, 327 U. S. 437, 459, 90 L. Ed. 772, 784, dissenting opinion of Mr. Justice Frankfurter). A situation much similar to the instant one was present before the Court in *White v. Winchester Country Club*, 315 U. S. 32, 41, 86 L. Ed. 619, 626, except that the Treasury Department's original interpretation was in favor of the tax sought to be collected, and by the time of the events under consideration it had reverted to that position.¹ This Court held that the views expressed by the Treasury Department shortly after the terms defined were first included in the Revenue Act were, as

“substantially contemporaneous expression of opinion . . . highly relevant and material evidence of the probable general understanding of the times and of the opinions of men who probably were active in the drafting of the statute. As such they are entitled to serious consideration, independently alike of re-enactments of the statute while it was in force on the books and of any temporary abandonment in consequence of disregard by judicial decision.”

¹There was also in this case a later definitive statute enacted subsequent to the transactions under consideration. With regard to this the Court said: “The legislative history of this redefinition is inconclusive in respect of the earlier intention of Congress. The action of Congress in thus explicitly defining the existing statutory term is at least as consistent with dissatisfaction on its part with the course of judicial decision as to its meaning as with the existence of an intention to change the law.” 315 U. S. at p. 39, 86 L. Ed. at p. 626.

III.

The Basis of the Decision Ignores the Long-settled Principle That Taxation Is Based Only on the Realization of Income.

The majority would tax as a crop realization the expectancy or potentiality of a future or expected crop. It has repeatedly been held that tax laws deal with actualities and are unconcerned with theoretical considerations. As indicated in the case of *Louise Owen v. Commissioner*, 192 F. 2d 106 (C. C. A. 5th), it is stated "as in other problems of taxation, the approach should be factual, not hypothetical." While it has been customary, in the citrus industry, to refer to an unharvested crop, it is actually a misnomer. The word "crop" connotes harvested fruit, or fruit that has been severed or "cropped" from the trees. When a grower refers to a so-called growing crop, he is doing so in *anticipation* of something that he expects he will have, according to the laws of nature, at a future time.

A "crop" of oranges cannot be "held for sale to customers * * *" until that crop of oranges comes into existence. The Court says, on page 6 of the decision:

"Each day brought the annual crop closer to its availability for sale in the ordinary course of that business. * * *"

But, if the crop did not in fact *exist* until the trees had produced it, it is plain that there was no crop being held for sale to customers or for any other purpose. We are speaking, here, of the trees and their fruit, but there is a parallel in the case of animate things. A sheep herder might anticipate a "crop" of lambs at the time he sells his flock of sheep, but certainly, he can not be said to be selling lambs which had not yet been born or produced.

Granted that each day brought the so-called crop closer to its availability for sale, it cannot be said the crop is *available* for sale in the ordinary course of the grower's business until it is harvested. It follows that fruit must be available and *exist* before it can be *held* for any purpose.

Conclusion.

We respectfully suggest that the primary basis for the decision of the majority of this Court is contrary to precepts of statutory construction previously applied in decisions of this Court. The majority opinion is also contrary to the prior decisions of this Court holding that tax laws deal with actualities and are not concerned with theoretical considerations.

We respectfully urge the Court to reconsider its decision, and pray the Court to order a rehearing so that the fullest possible consideration can be given to the consistent application of rules of statutory construction of revenue legislation. We respectfully pray the Court, on rehearing, to reverse the Court of Appeal and find for the petitioners.

Dated May 29, 1953.

Respectfully submitted,

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Certificate.

I, Arthur McGregor, of counsel for Ernest A. Watson and M. Gladys Watson, petitioners herein, do hereby certify that the foregoing petition for rehearing of this cause is presented in good faith and not for delay.

ARTHUR MCGREGOR,

Attorney for Petitioners.

Service of the within and receipt of a copy thereof is hereby admitted this.....day of May, A. D. 1953.
